Transcript Exhibit(s)

Docket #(s): RE-00000C-94-0165

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BEFORE THE ARIZONA CORPORATION COMMISSION

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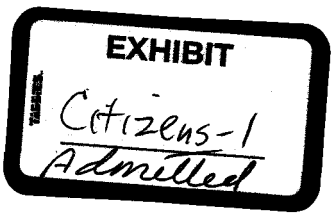

IN THE MATTER OF THE COMPETITION IN THE PROVISIONS OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. U-0000-94-165

NOTICE OF FILING

Citizens Utilities Company hereby provides Notice of Filing the Direct Testimony of Sean Breen as required by the Commission's Order in the above-referenced docket.

RESPECTFULLY SUBMITTED this 9th day of January, 1998.

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SUMMARY OF TESTIMONY

Mr. Breen's testimony presents the response of Citizens Utilities Company ("Citizens") to the nine questions set forth by the Arizona Corporation Commission ("Commission") in its December 1, 1997, Procedural Order in the Electric Competition Docket. Of greatest importance, Citizens urges the Commission to modify its Competition Rules in three key ways:

1. To provide unambiguous support for full recovery of prudently incurred costs stranded by the restructuring of the industry;

2. To adopt a market valuation method for valuing stranded costs and pursue a course of action that can rapidly, fairly, and efficiently introduce true open competition in the industry; and

3. To adopt a fair standard for judging the reasonableness of stranded cost mitigation efforts.

Mr. Breen's testimony also addresses Citizens' proposals to:

- delay the requirement for stranded cost filings until after the Rules have been updated;
- eliminate the Competitive Phases now contained in the Rules;
- require all customers to pay stranded costs;
- calculate stranded costs over remaining lives of the relevant assets;
- establish a recovery time frame that balances the goals of achieving the shortest possible period with minimizing rate impacts; and
- adopt a recovery method without price caps or the need for true-up mechanisms.

DIRECT TESTIMONY OF SEAN R. BREEN

CITIZENS UTILITIES COMPANY
ARIZONA ELECTRIC DIVISION

STRANDED COST PROCEDURAL ORDER

DOCKET NO. U-0000-94-165

JANUARY 9, 1998

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Q. Please state your name and position.

A. My name is Sean R. Breen. I am Director of Energy Services for Citizens Utilities Company.

Q. What are your relevant qualifications and experience?

A. I have been employed fourteen years in the electric utility business where my focus has been in the areas of resource planning, regulatory affairs and demand-side management. Over the last two years I have played a key role in conceptualizing, developing and presenting Citizens' position on competitive restructuring of the electric industry in Arizona and Vermont. Through this experience and perspective in the industry, I have gained insight and knowledge about the broad range of issues surrounding the re-regulation of electric utilities, including stranded cost valuation and recovery. Before joining Citizens in 1991, I worked eight years for Green Mountain Power Corporation, an investor-owned utility in Vermont, where I was responsible for key aspects of integrated resource planning and demand-side management.

Q. What is the purpose of your testimony?

A. My testimony provides Citizens' response to the questions concerning stranded costs set forth in the Arizona Corporation Commission's ("Commission") Procedural Order in Docket No. U-0000-94-165, dated December 1, 1997, as supplemented by amended Procedural Orders in the same docket, dated December 11, 1997, December 15, 1997, and January 5, 1998.

Q. How will your testimony be organized?

A. My testimony is divided into nine sections, each of which addresses one of the Commission's nine questions.

Q. Do you address the Commission's questions in the same order as presented in the Procedural Order?

A. No. As required by the First Amended Procedural Order, the questions and Citizens' responses have been re-arranged in order of importance to Citizens.

1. COMMISSION QUESTION NUMBER ONE

SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED REGARDING STRANDED COSTS, IF SO, HOW?

Q. Should the Electric Competition Rules be modified regarding stranded costs?

A. Yes.

Q. Why should the Rules be modified regarding stranded costs?

A. In its comments on the proposed rule submitted in November 1996 and in its application for rehearing submitted in January 1997, Citizens set forth four reasons why the Commission should modify the Rules regarding stranded costs. In summary, these reasons were:

1. The Rules would disavow the Regulatory Compact by which the Commission has required Affected Utilities to provide electric service in the past;

2. The Commission improperly dismissed as premature claims addressing the standards to be applied for stranded cost recovery;

3. The Rules fail to address or consider Citizens' showing that state regulatory agencies may not bar recovery through rates of the costs of wholesale power purchase contracts approved by the Federal Energy Regulatory Commission; and

4. The Rules fail to ensure that revenues from collateral services would not be improperly allocated to offset stranded costs.

Q. What is the nature of the regulatory compact referred to in statement 1 above?

A. Citizens, like utilities throughout the United States, is charged with the responsibility to serve all customers within a defined service area and is restricted in the amount it charges for service to rates that allow a reasonable return on and of the utility investments made to satisfy its obligation to serve. The regulatory compact balances the liabilities of the obligation to serve and an earnings cap against the rights to a reasonable return on and of the utility's prudent investment required to provide service and to recover prudent expenses.

Q. Why would the Rules violate the regulatory compact?

A. The current Rules would violate the regulatory compact to the extent they put utilities at risk to under-recover investments made and costs incurred that were required to provide service under the rules that existed, and are still in place in Arizona. This risk is clearly apparent when, in the explanatory statement accompanying Decision No. 59943, Staff contends that no regulatory compact exists.

Q. What is your understanding of the regulatory compact?

A. I am not a lawyer, so I will not cite cases, but will instead provide my basic understanding. In return for the Commission's granting Citizens a franchise and imposing upon it the continuing obligation to serve, Citizens, like other utilities, made investments in assets and entered long-term contracts with wholesale power suppliers to continue to meet this public service obligation. Citizens' shareholders' willingness to underwrite these long-term investments and commitments relied on the existing regulatory regime which provided Citizens the ability to recover its costs and earn a reasonable return on and of its investment through Commission-prescribed rates. Under the regulatory compact, once the

Commission has sanctioned contractual commitments and long-term investments, it cannot repudiate its obligation to provide utilities a reasonable opportunity to recoup these costs. The Rules as written jeopardize this opportunity.

Q. Moving to Citizens' second reason why the Commission should modify the Rules, what supports Citizens' belief that the Commission has dismissed claims addressing the standards to be applied for stranded cost recovery?

A. Within the Explanatory statements in Decision No. 59943, Staff asserts that arguments concerning stranded cost recovery are premature – that the Rules merely set forth a process for future requests for recovery of these costs. However, the Rules set forth several factors that the Commission "at least" shall consider in making determinations about stranded cost recovery. Consideration of these factors would actually tilt the playing field in favor of non-recovery.

Q. Please explain further.

A. It is the existence of these considerations (listed in A.A.C. R14-2-1607) that in fact undermines the reasonable opportunity for full recovery of costs stranded by electric competition. For instance, while the "impact of Stranded Cost recovery on the effectiveness of competition," is a legitimate concern that should guide the design of the recovery mechanism, it has no place in determining the amount of recovery to which an Affected Utility is entitled. To the extent the Commission employs any of the considerations listed to materially reduce recovery of a utility's stranded cost, it would create confiscatory earnings levels for the investment made under the regulatory compact.

Q. Why do you characterize the denial of stranded cost recovery as creating confiscatory earnings?

A. This is a direct result of: 1) the character of the government action; 2) the economic impact of the regulation; and 3) the extent of interference with investment-backed expectations.

Q. In what way does the "character of the government action" contribute to this issue?

A. In this situation, the government action is a pervasive transformation of the electric industry to introduce competition. To the extent this transformation denies full stranded cost recovery, it would frustrate utility investors' interest in the continuing recovery of costs incurred to meet the utility's obligations. The "character" of this action is revealed by the reasonableness of the means selected for obtaining the regulatory goal. There is no reasonable basis for concluding that the Commission's decision to promote competition **requires** denial of full recovery of costs incurred under regulation. In fact, imposing stranded costs upon the Affected Utilities would hamper their ability to compete against new market entrants, thereby frustrating competition.

Q. Would the economic impact of the denial of stranded cost recovery be substantial?

A. Yes. While there is yet no single, widely-accepted estimate of Arizona utilities' stranded cost exposure, estimates run into the billions of dollars. These costs represent utilities' prudent investments and commitments, undertaken to serve the public and approved for inclusion in rates. Clearly, the denial of recovery of these amounts, or even a fraction of the costs, would potentially cause serious financial loss that could very well threaten the continued viability of the Affected Utilities.

Q. What would be the "extent of interference with investment-backed expectations" from denial of stranded cost recovery?

A. Denial of recovery would represent severe interference. It is beyond dispute that the disallowance of stranded cost recovery interferes with utility investors' reasonable investment-backed expectations of recovery of – and a return on – their investments, as well as recoupment of expenses.

Q. What do these three factors mean?

A. Considering these factors together: the unreasonable nature of the governmental action; the substantial degree of economic impact; and the severe interference in investment-backed expectations; it is clear that denial of the opportunity for full stranded cost recovery represents a confiscation of utility property.

Q. Turning to Citizens' third issue concerning recovery of stranded costs, how do the Rules fail to adequately address FERC jurisdictional issues?

A. Virtually all power now provided to Citizens' electric customers is supplied by Arizona Public Service ("APS") under a wholesale purchased-power agreement. The cost for this power is passed directly to Citizens' customers, without mark-up, through a purchased power and fuel adjustment clause ("PPFAC"). Accordingly, unlike utilities that have substantial generation assets, Citizens has not and does not earn a return on the substantial portion of the power requirements of its customers. The rates paid by Citizens for this power are set by the FERC, which has exclusive jurisdiction over wholesale sales under the Federal Power Act. The filed rate doctrine prohibits the Commission from adopting retail rates that do not allow full recovery of these costs. As a result, the filed rate doctrine will invalidate any approach to stranded cost recovery that leads to under-recovery of the APS power purchase contract costs.

Q. What is the filed rate doctrine?

A. Again, I am not a lawyer, but will present my basic understanding. The filed rate doctrine provides that rates filed with and approved by the FERC may not be altered at the state level, and that state commissions may not bar local distribution companies from passing such costs through to ratepayers. Denying Citizens the ability to collect its full wholesale power costs would violate this doctrine.

Q. Is this the first time Citizens has alerted the Commission of this issue?

A. No. In its November 1996 comments on the Proposed Order regarding electric competition, Citizens explained the impact of the filed rate doctrine on Citizens' potential recovery of its power costs. The Commission did not address this portion of Citizens' comments in the explanatory statement accompanying the subsequently amended rule.

Q. Has the Commission required Citizens to maintain its PPFAC to provide for full recovery of the costs incurred through its purchased power contracts with APS?

A. Yes, it has. The Commission has rejected two attempts by Citizens to eliminate its PPFAC and has ordered Citizens to continue recovery of its purchased power costs through the PPFAC.

Q. Did the Commission recognize that Citizens was different from the other major electric utilities when ordering Citizens to retain the PPFAC?

A. Yes. The Commission determined that Citizens was not a generating utility and purchased its power through contracts with APS.

Q. Was Citizens granted any earnings on the PPFAC bank balance that was maintained to ensure that 100 percent of the purchased power costs were passed through to its customers?

A. No. The Commission permitted only a dollar-for-dollar recovery.

Q. Has the Commission found that the long-term purchased power contracts between Citizens and APS, which were approved by the FERC, were reasonable and should be recovered from Citizens' customers?

A. Yes. They were approved for recovery through the PPFAC in Citizens' last electric rate case.

Q. Has the Commission, or any party to this proceeding, presented any facts that those same contracts have been modified?

A. No.

Q. Why are these facts about Citizens PPFAC relevant to the recovery of stranded costs?

A. These facts underscore that Citizens' shareholders have received no benefit from the power supply contracts approved by the Commission. In fact, the Commission rejected Citizens request to be at risk for changes in the cost of purchased power and allocated all benefits and costs to customers. Putting aside the filed-rate doctrine, it would be fundamentally unfair to cause shareholders to absorb any stranded costs associated with purchase-power contracts when:

- shareholders have earned nothing on these payments;
- the Commission has found the purchases to be prudent; and
- customers have already received refunds when power costs declined below forecasted levels.

The Commission cannot fairly saddle shareholders with stranded costs associated with an approved contract, from which shareholders have never received any benefits.

Q. What is the only event that is causing concern as to the recovery of the costs associated with those contracts?

A. The only event is the Commission's effort to re-regulate the electric utility industry. While Citizens does not disagree with the Commission on the goal, the Commission cannot summarily disregard 87 years of its past practice; it must provide an acceptable transitional mechanism to permit full recovery of all costs associated with providing service under the existing regulatory rules.

Q. Looking now at Citizens' fourth concern with stranded cost recovery, how would the current Rules improperly allocate revenues from collateral services to offset stranded costs?

A. A.A.C. R14-2-1607 states: "The Affected Utilities shall take every feasible, cost-effective measure to mitigate or *offset* Stranded Costs by means such as expanding wholesale or retail markets, *or offer a wider scope of services for profit, among others."*(Emphasis added.) The Rules as now stated would improperly include revenues from all sources/services – even those unrelated to the incurrence of stranded costs or the provision of utility services.

Q. Why does this matter?

A. Citizens agrees that utilities should be required to make reasonable efforts to mitigate avoidable stranded costs. However, this portion of the Rules states that revenues derived from other aspects of the Affected Utilities' operations, including aspects unrelated to the stranded costs or utility operations, should be used to reduce the level of recoverable stranded costs. With the introduction of electric

competition, a utility may make new at-risk investments in competitive markets. If the utility were required to divert revenues from these unrelated activities to offset stranded costs it would be unable to fairly compete against new market entrants that had no stranded costs to offset.

Q. Is this the first time Citizens has alerted the Commission of this issue?

A. No. In its comments on the Proposed Order on Electric Competition Rules submitted in November 1996 and again in its Application for Rehearing submitted in January 1997, Citizens provided extensive reasons why revenues from collateral services should not be used to offset stranded costs. None of these concerns were addressed or considered in Decision No. 59943.

Q. In what way should the Rules be modified regarding stranded costs?

A. A number of changes should be made to the Rules; I will address the details of our proposed changes in the responses to other Commission questions. Here, Citizens proposes that the Commission adopt the following three general principles to guide the recovery of stranded costs:

1. *Full recovery of unmitigated stranded costs should be a rebuttable presumption.* Once a utility has made a showing of its efforts and results for mitigating its stranded costs, the burden of proof that the utility has not taken all reasonable steps should be on the party opposing full recovery.
2. *Impacts on the marketplace of stranded cost recovery (e.g. on effectiveness of competition, on prices paid, etc.) are considerations relevant to the design of the recovery mechanism, but not to the recoverability of stranded costs.* While it is proper for the Commission to develop mechanisms for recovering stranded costs that do not cause undue economic impacts, the existence of the potential for such

impacts in no way undermines the principle that mitigated stranded costs are fully recoverable.

3. *Offsets to stranded costs as a form of mitigation are relevant only to activities or services directly related to current or future regulated utility services.* The revenues from an expanded array of competitive services that are unrelated to incurrence of stranded costs should not be used to reduce the level of stranded costs that are recoverable.

2. COMMISSION QUESTION NUMBER THREE

WHAT COSTS SHOULD BE INCLUDED AS PART OF STRANDED COSTS AND HOW SHOULD THOSE COSTS BE CALCULATED?

Q. What costs should be included as part of stranded costs?

A. Citizens agrees with the current Rules' definition of stranded costs and generally concurs with the components of stranded costs defined in Stranded Cost Working Group report. However, Citizens would point out that there are two additional areas of strandable costs that are not fully addressed in the Working Group Report.

Q. What are these additional areas of strandable costs?

A. The two additional areas are non-generation-related costs and the costs of new functions that will be required by a regulated local distribution company ("LDC") under open access.

Q. Please explain what you mean by "non-generation-related costs."

A. The Stranded Costs Working Group Report does not fully address the stranded cost potential associated with non-generation utility functions including: metering and meter reading, billing and collections, and customer information services. As Staff points out in the Report: "Although the focus of this analysis was directed

toward potentially strandable generation costs, Staff believes that it is appropriate to recognize that, to the extent any portion of the affected utilities' distribution business (i.e. customer metering and billing) is similarly removed from the scope of regulation, additional stranded costs may result." (See page 14.) While these strandable costs are in all likelihood of lower magnitude than generation costs, they are potentially strandable and should be accorded the same reasonable opportunity for full recovery.

Q. Please explain the new functions required of regulated operations under open access.

A. Introducing competition fundamentally changes the structure of the industry, not only to the extent that it creates new competitive enterprises, but also how it will change the operations of those components that will remain regulated. For instance, continuous tracking, accounting, and reconciling energy supply and demand transactions between distribution customers and tens, possibly hundreds, of electricity suppliers will require LDC's to implement and operate new systems Educating customers about how the industry is changing and how these changes affect the way they will purchase electricity is another example of a significant new activity that will fall to the LDC. The costs for start-up and on-going operation of these functions are not currently reflected in the rates of any Arizona utility, nor can any Arizona utility determine these costs at this time, given that the structure and requirements of the restructured industry have not been fully defined. Although these costs may not satisfy the definition of "stranded" costs (these will be newly-incurred, instead of pre-existing), the Commission should definitely provide for their recovery.

Q. What is Citizens' proposal for the treatment of these implementation costs?

A. There are two components of these implementation costs: start-up/one-time costs and on-going costs of operation. The start-up/one-time costs for these new functions, while not technically "stranded," should nonetheless be recoverable as part of customer charges for the transition to open access, sometimes call "competitive transition charges" ("CTC"). Just as stranded costs result from regulatory restructuring, these new functions also result from regulatory restructuring.

Q. What about the on-going costs for these new functions?

A. Since the on-going costs for these new functions will be caused mainly by those customers who elect competitive suppliers, the on-going operating expense for these new functions should reasonably be borne by the new market entrants and consumers participating in and enjoying the benefits of the competitive electricity market.

Q. Turning to the second part of Question Nine, how should stranded costs be calculated?

A. For the vast majority of stranded costs associated with electric generation, Citizens firmly supports a market valuation method for determining stranded costs. In particular, Citizens proposes that the value of generation-related stranded costs be determined through a state-administered auction of generation assets and purchased power contracts. Stranded costs would be established as the difference, if any, between the auction proceeds and book value of the assets (or contract obligations in the case of purchased power contracts).

Q. Does this mean Citizens favors forced divestiture?

A. No. Participation in the auction would be voluntary. Any Affected Utility would be free to enter the competitive market using its existing generation resources. However, if an Affected Utility seeks to recover the above-market costs for **any** of its generation resources, it could do so only be putting up **all** its resources for sale in the auction.

Q. Why is Citizens proposing this requirement?

A. By putting up all generation resources, the magnitude of stranded costs is mitigated to the extent an Affected Utility owns below-market price resources which offset a portion of its above-market price resources. It stands to reason that, if a utility seeks recovery of costs stranded by above-market resources incurred under the regulatory compact, it should be prepared to relinquish offsetting below-market resources acquired under the same compact.

Q. Are there any exceptions to putting up **all** generation for auction under Citizens' proposal?

A. Yes. Generation that is required for emergency back-up, local voltage support, or other reliability function for the utility's transmission and distribution system would not have to be put up for auction. The costs for these assets are more properly recovered as part of a regulated utility's transmission and/or distribution charges. Nuclear powered generation could also be separately administered.

Q. Please explain the mechanics of the auction process.

A. Under Citizens proposal, the auction would be administered by a state agency, the Investment Recovery Fund Department ("IRFD"), under the supervision of the Commission. The mechanics of the actual auction, such as solicitation and evaluation of bids would be handled by an investment banking or other

comparable advisory firm hired by the IRFD. This firm would be able to assess the likely valuation of the assets to be sold at auction and determine how the auction should be structured to realize the highest price for the total portfolio. The firm should also be experienced in the actual conduct of the auction. The IRFD would establish the rules for the auction, and would provide detailed information concerning the assets and contracts to be auctioned to all interested parties, subject to reasonable protections for confidential information. The auction rules may require bidders to pre-qualify, or to provide certain evidence of creditworthiness, to discourage frivolous bids and minimize auction expenses. The actual conduct of the auction, i.e. open or sealed bid, single or active bidding, would be determined by the IRFD.

Q. Please discuss the financial transactions that would then take place.

A. The IRFD would pay Affected Utilities original cost less depreciation for generation assets. Purchase rights under purchase power contracts would be assigned to the IRFD. The difference between the proceeds from the auction and the total net book value paid out to the original owners, plus the difference between contractual purchased power prices and the prices garnered in the auction, would then constitute the stranded costs. The stranded costs of all participating utilities would be pooled in the Investment Recovery Fund and be re-financed (secured) by tax-exempt state revenue bonds or corporate bonds backed by enabling legislation. If feasible, the IRFD would also administer the refinancing of stranded costs and would be the issuing authority for the securities that would fund the recovery of utilities' stranded costs. Securitizing stranded costs would likely mitigate the overall level of stranded costs because credit ratings of securities backed by future cash flow from the utilities' stranded cost recovery would likely receive a higher rating than the average of the individual ratings for the senior debt of the issuing utilities.

Q. Could Affected Utilities bid for their previously-owned assets under Citizens' approach?

A. Yes. Any unregulated affiliates of the Affected Utilities could participate in the bidding process and also bid on any assets or contracts.

Q. What are the advantages of this approach?

A. There are several, chiefly including:

- risk transfer;
- mitigation of stranded costs;
- rapid transition to true open competition; and
- reduction of horizontal market power.

Q. In what way would Citizens' proposal transfer risk?

A. Bidders in the auction would base their bids on what they believe future market prices for power will be. By purchasing generation assets or contracts, successful bidders would assume price forecasting risk, and in particular, the risk that future power prices would be lower than projected. By contrast, under administrative approaches that employ true-up mechanisms, customers would bear the risks of under-forecasting future prices, and pay the differences between established stranded charges and the actual amounts of above-market costs on a forward-going basis.

Q. Is there a possibility that, under Citizens' approach, electric customers could pay more for stranded costs than what they otherwise would under an administrative approach?

A. Yes there is. However, there is at least an equal chance that customers would pay less. Further, under Citizens' approach, customers would know exactly their

liability for stranded costs. Under administrative approaches, where customers shoulder the risk that future prices may be lower than projected, there would be no certainty about the magnitude of stranded cost liability.

Q. Please explain how Citizens' approach would mitigate stranded costs.

A. There are three main ways Citizens' proposal would mitigate stranded costs: by, 1) requiring below-market resources to be included in the auction; 2) refinancing stranded costs with low-cost bonds; and 3) holding the auction while the marketplace is still in transition.

Q. You have discussed how below-market resources and low-cost bonds could mitigate stranded costs; how can holding the auction while the marketplace is still in transition mitigate stranded costs?

A. The restructuring of the electric industry across the country has produced a fury of new business activity, as new market entrants jockey for position to acquire a share of the new multi-billion dollar per year market for competitive power. In Massachusetts, California and Maine, where auctions of utility generation assets and purchase power contracts have been held, the sales proceeds have exceeded the underlying book value of the resources sold by wide margins. For instance, Southern California Edison has recently selected winning bidders for its sale of over 7500 MW of gas-fired generation plants and garnered a sales price 2.65 times the book value of the plants in aggregate. Pacific Gas & Electric also selected a winning bidder for three of its California plants that agreed to pay a price 30% higher than book value. In Massachusetts, New England Electric System sold over 5000 MW of fossil-fuel and hydroelectric facilities for 45% over book value. Recently, Central Maine Power selected the winning bidder in its sale of 1185 MW of generation that offered 3.5 times book value. Part of the reason these premiums have been earned is linked to investors' expectations about profit

potential inspired by the newness of the market opportunity. Coupled with a robust competitive bidding process, these expectations can contribute to higher prices in the auction process. Reports in industry periodicals suggest that divestiture will be good for utilities that undertake it in the near-term. Arizona remains on the leading edge of industry restructuring nationwide. Arizona can secure these advantages if it quickly adopts Citizens' auction approach to stranded cost valuation.

Q. Please explain other advantages of a rapid transition to open competition.

A. Administrative approaches to stranded cost valuation will likely require time-consuming, litigious, and expensive true-up proceedings for many years into the future. In addition to the continuing expense, ongoing regulatory involvement in the process will create motivations for gaming and could undermine investor confidence. Under Citizens' approach, no true-up mechanisms or proceedings are needed. In short, it will bring true open competition to the power supply industry "overnight," and disentangle the Arizona power supply industry from any further encumbrance of price regulation.

Q. What is horizontal market power and how does Citizens' approach reduce its potential?

A. Horizontal market power in the power production chain could result if a limited number of market participants controlled a majority of the competitive resources, thereby resulting in barriers to entry to new market players or too few market participants. While bringing a number of other benefits, Citizens' approach can effectively eliminate potential horizontal market power that may be held by existing Affected Utilities. Whether this is an issue in Arizona is a judgment the Commission must make.

Q. Did the Stranded Cost Working Group Report cite disadvantages to Citizens' auction approach.

A. Yes, it did. However, all of those cited are avoidable or not valid.

Q. What were the disadvantages cited?

A. In summary they were:

- Administration costs
- Potential for "fire sale" prices
- Uncertainty about number of bidders
- Administrative hurdles
- Lack of Commission authority
- Inaccurate estimates of stranded costs
- Limited bidders for nuclear facilities
- FERC rules already limit market power

Q. Are the administrative costs of Citizens' approach a valid issue?

A. No. Citizens' approach, while requiring some up-front administrative work to arrange the auction and refinancing processes, would be inexpensive compared to administrative methods for valuation which will inevitably involve multiple parties litigating over the "correct" forecast of market prices initially and during subsequent true-up proceedings.

Q. Isn't it true that a sale of assets within a short time frame could lead to "fire sale" prices and potentially not attract many bidders?

A. In theory, yes, however, controlling the timing of the sale can avoid these potential pitfalls. For instance, conducting the auction in stages over some span of time or scheduling to avoid overlap with similar activities in nearby states are two obvious ways to mitigate these concerns. Further, the experiences in other jurisdictions has been the opposite -- bidding has been robust and prices have exceeded book values.

Q. What are the administrative hurdles presented by Citizens' proposal?

A. The Stranded Cost Report characterizes as "tremendous" the administrative hurdles such as unwinding current power supply contracts, soliciting stockholder approvals, and obtaining releases of mortgaged property from bond trustees. These issues no doubt will be challenging. But, Arizona need not re-invent the wheel. These issues have been successfully resolved in other states. The restructuring of the electric industry does present some "tremendous" administrative hurdles that will require innovation and creativity to overcome, however Arizona can piggyback on these pioneering states' experience.

Q. Does the Commission lack authority to order asset sales and divestiture?

A. Under Citizens' approach it does not matter if the Commission has such authority or not; participation in the auction is voluntary. Utilities who want to enter the competitive market with the power resources they hold are free to do so.

Q. Isn't it true that marketplace uncertainty may lead to inaccurate forecasts of stranded cost estimates by bidders?

A. Yes, it may. However, as I've previously discussed, Citizens' proposal would shift a large portion of the risk to the market from the customers, so this is an advantage, not a disadvantage. Further, future price risk is a given in any competitive market. Billions of dollars are traded daily by investors based on their own imperfect, (and often inaccurate) forecasts of future prices. The risk to avoid is under-valuation based on an overall expectation of low future prices. Two ways to mitigate this risk are through timing and use of floor prices. As I have described, holding the auction while the market is still in transition may very well lead to higher prices than could otherwise be obtained. Also, while overly restrictive terms and conditions in the auction process should be avoided, the use

of floor prices for the auctioned assets would limit downside risk. The floor price could represent, for instance, that price that would lead to the highest acceptable level of stranded cost.

Q. Isn't it true that the field of potential bidders would be limited for nuclear facilities?

A. It is true that there will likely be fewer qualified bidders for nuclear facilities than for other generation sources, but that does not mean that an adequate number of bidders would not be available. Given the number of nuclear facilities across the country, there are a number of qualified parties (e.g. unregulated affiliates of electric utilities) who potentially may bid. San Diego Gas & Electric recently announced plans to divest its holdings in the San Onofre Nuclear Generation Station. It will be telling to monitor the number of qualified bidders who participate in that bid process. Further, nuclear asset auctions could be separately administered or the assets could even be left out of the auction process.

Q. Is it true that the FERC open-access transmission rules sufficiently mitigate the potential for utilities to exercise market power in generation, thereby rendering moot a perceived key benefit of auctions?

A. Perhaps, but that is a judgment that the Commission must make. Apparently, the California Public Utilities Commission concluded otherwise – at least in the case of Southern California Edison and Pacific Gas & Electric – who were requested to divest (and both complied) at least half of their generating capacity to mitigate market power.

Q. What are the implications of the Statement of Financial Accounting Standards (SFAS) No. 71 resulting from Citizens' stranded cost valuation and recovery methodology?

A. I am not an accountant, but will provide my basic understanding. With respect to generation-related assets, Citizens' approach can effectively avoid the potentially onerous financial issues raised by SFAS 71 (and the related statements, SFAS 101 and 121) in association with the valuation and recovery of stranded costs.

Q. Why is this so?

A. This is so because Citizens' approach avoids the need for utilities to continue to carry above-market generation assets on their books. When utilities face the loss of their categorization as a "regulated enterprise" as a result of the deregulation of the electric industry, they are faced with writing off all regulatory assets and liabilities (under SFAS 101). To the extent a utility retains above-market generation based on a regulatory order stating it is entitled to recover the above-market portion through rates, its financial future is predicated upon a regulatory asset. Under Citizens' approach, that regulated utility would have divested its interest in the generation assets (at book value), so the issue becomes moot.

Q. What about existing regulatory assets like deferred DSM costs?

A. Under Citizens' approach, utilities would receive from the IRFD the current value of existing regulatory assets. These amounts would be included in the statewide IRFD stranded cost pool that would ultimately be refinanced with State bonds or legislatively-backed corporate bonds. In this way, the potential write-off of these amounts under SFAS 71 and 101, which would likely result from use of an administrative approach, would be avoided under Citizens' approach.

3. COMMISSION QUESTION NUMBER NINE

WHAT FACTORS SHOULD BE CONSIDERED FOR MITIGATION OF STRANDED COSTS?

Q. Is it possible to create a finite list of "every feasible, cost-effective measure" that utilities must take to mitigate stranded costs?

A. No. In all probability, such a list of measures could not be created. The ability to mitigate stranded costs depends entirely on the particular circumstances of each utility. It is improbable that a list of *every* possible option that addresses the individual circumstances of each utility could be reasonably prepared. For instance, in the case of utilities, like Citizens, with strandable long-term purchased power agreements, no one could list every conceivable negotiating strategy or option that may be used to re-negotiate agreements.

Q. What does this imply concerning the current standard in the Rule that the "Affected Utilities shall take every feasible, cost-effective measure to mitigate or offset Stranded Costs..."

A. The standard that *every* measure be taken is not achievable. It would always be possible to demonstrate a new "twist" that was not pursued.

Q. What standard should be applied?

A. In this instance, where the Commission has found that the existing investments or costs are reasonable for setting utility rates, the burden of proof for non-recovery of these costs must be placed on the party that is recommending the non-recovery. While Affected Utilities should be required to vigorously pursue reasonable means to mitigate stranded costs, as a result of the regulatory compact, the Affected Utilities must be given the starting point that unmitigated

amounts are recoverable. That is, unmitigated stranded costs would be deemed fully recoverable unless a party could demonstrate the Affected Utility did not make reasonable mitigation efforts.

Q. How should the Commission judge the reasonableness of mitigation efforts?

A. Each Affected Utility should make a showing of all mitigation measures it has taken, the results of those measures, and an explanation of measures considered but rejected. The burden of proof that the Affected Utility in fact did not make adequate mitigation efforts would fall on the party seeking denial of full recovery of the stated level of unmitigated stranded costs. The Commission should judge the reasonableness of a utility's mitigation efforts by the weight of the evidence that there are additional mitigation measures that could have been reasonably implemented, and/or that the utility failed to fully pursue the measures it selected. The party seeking denial must be prepared to show that the actions it proposes had a reasonable chance of succeeding and would have resulted in greater mitigation than achieved by the Affected Utility.

Q. What is the key distinction here?

A. The key distinction is that the burden of proof is on the party seeking denial of full recovery, not on the utility to demonstrate it has taken *every* measure possible. It is not sufficient for a party to simply identify a possible mitigation alternative not taken as the basis for denial of recovery. It must also prove that the alternative could be reasonably implemented.

Q. Regarding the considerations contained in the Rules under R14-2-1607(I), can the Commission properly employ these considerations to limit, or in effect "mitigate" the magnitude of stranded costs that are recoverable by Affected Utilities?

A. No. As I have stated earlier, the Commission would cause confiscatory earnings levels, if it employed any of the listed considerations in determining the amount of stranded costs that would not be recoverable by an Affected Utility. Certain of these considerations could properly be employed to determine the design of the stranded cost recovery mechanism, but not the total amount recoverable.

4. COMMISSION QUESTION NUMBER TWO

WHEN SHOULD AFFECTED UTILITIES BE REQUIRED TO MAKE A STRANDED COST FILING PURSUANT TO A.A.C. R14-2-1607?

Q. When does Citizens believe stranded cost filings should be made?

A. Stranded cost filings should not be required until well after the rules governing the introduction of competition into the Arizona electric industry have been finalized. Through its Decision No. 60351, the Commission set in motion a process to, in effect, re-visit approved rules A.A.C. R14-2-1601 through R14-2-1616. The decision to do so was, in part, based on allowing consideration of the findings of the various working groups that have submitted reports on their activities and recommendations. A review of these reports shows that a host of issues concerning electric competition remain to be resolved. Further, the present hearings will provide additional evidence for the Commission to consider. Until the Commission reviews all the evidence and provides further guidance, it is simply not possible for Affected Utilities to make responsive stranded cost filings. Once the Rules have been established with finality, Affected Utilities should be allowed a reasonable opportunity to consider the impact of the changes that have been made, and to restructure their businesses accordingly. Not knowing the scope of changes to the Rules that may be made, Citizens does not have a specific recommendation for what span of time would be appropriate, but would suggest that it should reflect the extent of the changes made.

Q. How does the need to finalize the Rules affect the date to implement electric competition in the current Rules?

A. The time needed to resolve the stranded cost issues (not to mention the host of other yet-resolved issues identified in the working group process) could well absorb most of the time remaining before the Rules' January 1, 1999, implementation date. Citizens encourages the Commission to act quickly to set a more realistic date for initiating electric competition.

Q. What should be the schedule to implement open competition?

A. Citizens favors starting competition for a manageable number of large commercial and industrial customers (for instance those with loads exceeding 3 MW) as soon as practicable, and to "flash-cut" to open competition for the remainder of customers at a later time, for instance in 2000 or 2001. This schedule would allow for the orderly resolution of stranded cost issues, the Commission's reconsideration of other aspects of the Rules, and the resolution of the other administrative/logistical issues raised by the working groups.

5. COMMISSION QUESTION NUMBER SIX

HOW AND WHO SHOULD PAY FOR STRANDED COSTS AND WHO, IF ANYONE, SHOULD BE EXCLUDED FROM PAYING STRANDED COSTS?

Q. Who should pay for stranded costs?

A. Citizens generally supports the consensus position of Stranded Cost Working Group that all customers should pay for stranded costs and that the charge to standard offer customers should account for contributions that are already being made toward stranded costs. However, the Rules' Competitive Phases create a significant equity issue.

Q. What equity issue is created?

A. The Competitive Phases included in the current Rule will create two classes of customers: those who can choose their supplier and those who can not. It would not be equitable to charge stranded cost fees to customers who can not participate in the competitive market. Citizens agrees with the argument that recovering stranded costs from all customers will shorten the needed recovery time frame – a desirable outcome. This is all the more reason for eliminating Competitive Phases in favor of a "flash-cut" to open competition at a later date, after matters are resolved and adequate preparations are made.

Q. How should stranded costs be recovered?

A. Stranded costs should be recovered through a non-bypassable charge levied by the LDC that remains regulated. This charge should be uniform across all Affected Utilities and be levied over a consistent time frame.

Q. Why is establishing a uniform stranded recovery charge good policy for Arizona?

A. The restructuring of the electric industry should not result in economic disparities across Arizona as a result of the resources acquired under regulation. Moving to open competition by electric suppliers fundamentally alters the rules and regulations under which the electric utility industry has operated. Given that this fundamental rule change will potentially affect all Arizona electric customers, it stands to reason that the costs for this change (stranded costs) should be born equally by all Arizona electric customers across the State without regard to service area. This is why Citizens' proposes to conduct a state-level generation asset sale, pool stranded costs, and recover them on a uniform basis statewide.

Q. How would stranded cost recovery fees be established under Citizens' proposal?

A. Stranded costs would be recovered using a flat monthly charge (i.e. not tied to kWh or kW consumption) based on historic usage levels. Thus, for example, residential customers using 0 to 5000 kWh/year would pay, say $5/month, while customers who historically have used 5001 to 10,000 kWh/year would pay $10/month, etc. These charges would be established based on the total statewide stranded costs and the distribution of usage levels by customers across the state. Customers with identical historical usage levels would pay the same stranded cost charge (over the same time frame) whether located in APS', TEP's, Citizens', or any other Affected Utility's service area. On a forward-going basis, flat charges for stranded costs would be the least distorting because they would not affect the marginal cost for electricity and, therefore, consumption or production decisions.

Q. Should anyone be excluded from paying stranded costs?

A. No. All customers served by the LDC of Affected Utilities should pay for costs stranded by the restructuring of the industry.

6. COMMISSION QUESTION NUMBER FOUR

SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH STRANDED COSTS ARE CALCULATED?

Q. Does Citizens support a limitation on the time frame over which stranded costs are calculated?

A. In general, no. The calculation time frame over which stranded costs are calculated must be consistent with the remaining service lives for generation assets, the remaining contract term for purchased power contracts, and the remaining amortization period for regulatory assets to allow for full recovery of

stranded costs. Anything short of this would result in denial of full stranded cost recovery. On this issue, Citizens concurs with the findings in the report of the Stranded Cost Working Group.

7. COMMISSION QUESTION NUMBER FIVE

SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR STRANDED COSTS?

Q. Does Citizens support a limitation on the period over which stranded costs are recovered?

A. Yes, but a time frame for recovery can only be established by balancing the goals of achieving the shortest possible recovery period and minimizing the impact on rates. Citizens does not support arbitrarily setting a recovery time frame without considering the magnitude of the resulting economic impacts. Under administrative approaches with true-up mechanisms, it would be impossible to establish up-front a time frame that balances these goals because the full extent of stranded costs would not be known. However, under Citizens' approach, where stranded costs are determined up-front with finality, it would be possible to calculate the rate impact as a function of time frame and make a reasoned decision about the appropriate length of the recovery period. Further, under Citizens' recovery proposal, where stranded costs are pooled statewide, there would be a uniform recovery charge for a pre-determined period that is the same across the State. This feature would eliminate the creation of economic disparities across Arizona depending on the stranded costs of the local utility.

8. COMMISSION QUESTION NUMBER EIGHT

SHOULD THERE BE PRICE CAPS OR A RATE FREEZE IMPOSED AS A PART OF THE DEVELOPMENT OF A STRANDED COST RECOVERY PROGRAM AND IF SO, HOW SHOULD IT BE CALCULATED?

Q. Should there be price caps or a rate freeze imposed as part of the development of a stranded cost recovery program?

A. Citizens opposes any price cap or rate freeze that results in a *de facto* disallowance of unmitigated stranded costs. For the variety of reasons I have given earlier in my testimony, utilities must be provided a reasonable opportunity for full recovery of unmitigated stranded costs.

9. COMMISSION QUESTION NUMBER SEVEN

SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO, HOW WOULD IT OPERATE?

Q. Does Citizens' stranded cost recovery proposal incorporate a true-up mechanism?

A. No. No true-up mechanism is needed under Citizens' proposal. Stranded costs are determined at the outset of competition and no further adjustments are made. The true-up mechanisms envisioned under administrative approaches will inevitably trigger contentious litigation and in effectively prolong the regulation of power supply.

Q. Does that conclude your testimony?

A. Yes, it does.

BEFORE THE ARIZONA CORPORATION COMMISSION

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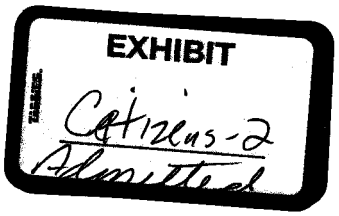

IN THE MATTER OF THE COMPETITION IN THE PROVISIONS OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA	))))	DOCKET NO. RE-00000C-94-0165 **NOTICE OF FILING**

Citizens Utilities Company hereby provides Notice of Filing the Rebuttal Testimony of Sean Breen as required by the Commission's Order in the above-referenced docket.

RESPECTFULLY SUBMITTED this 4th day of February, 1998.

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SUMMARY OF REBUTTAL TESTIMONY

Mr. Breen's rebuttal testimony presents the response of Citizens Utilities Company ("Citizens") to various arguments set forth by the parties concerning the level of stranded cost recovery and market valuation of stranded costs. Mr. Breen's rebuttal testimony demonstrates that:

1. Regulatory policy does not support denial of costs stranded by industry restructuring. In fact it would be bad policy if regulators failed to honor past regulatory commitments;

2. There is no evidence that shareholders have been compensated for the risk of denial of stranded cost recovery. Risk premiums have not included compensation for the risk of regulators reversing past decisions on cost recovery; and

3. Stranded cost recovery need not create adverse market impacts if the proper method is selected to value stranded costs and the appropriate recovery methodology is chosen.

Finally, Mr. Breen's rebuttal testimony urges the Commission to allow sale of generation assets and contracts, under guidelines it dictates, as one acceptable means for stranded cost valuation.

Q. Please state your name and position.

A. My name is Sean R. Breen. I am the Director of Energy Services for Citizens Utilities Company.

Q. Are you the same Sean R. Breen who submitted direct testimony in this proceeding?

A. Yes, I am.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to two key issues concerning stranded costs raised by the various parties to this case: the level of recovery and the method of valuation.

Q. Does the limitation of your rebuttal to these matters mean that you have no opinion on or no objection to other positions taken or issues raised by the parties to this case.

A. No. I am limiting my rebuttal to focus the debate on those areas which are of greatest importance to Citizens.

Q. Regarding the first issue, are you persuaded by the testimony of the other parties to this case that utilities should be limited to something less than full recovery of stranded costs?

A. No, I am not, nor should the Commission be. None of the reasons cited for less than full recovery of stranded costs is valid.

Q. What reasons were cited for less than full recovery?

A. Several witnesses assert that shareholders should bear all or a portion of the costs stranded by the re-regulation of the industry. Their arguments generally fall into three key areas: Regulatory Policy; Shareholder Risk and Responsibility; and Market Impacts. I will address each of these areas in my rebuttal testimony. Before doing so, I make one over-arching observation. Several parties to this case have set forth long and elaborate arguments for having shareholders shoulder the cost for changing the rules of regulation, however none of these come close to justifying the unavoidable truth in this matter: denial of stranded cost recovery is no different than defaulting on a contract.

Q. What do you mean by "stranded costs?"

A. By "stranded costs," I mean net stranded costs after mitigation. As I stated in my direct testimony, Citizens agrees that Affected Utilities should be required to vigorously pursue reasonable means to mitigate any costs stranded by industry re-regulation.

Q. Referring to the first argument based on Regulatory Policy, what are the specific reasons cited for less-than full recovery of stranded costs?

A. The Regulatory Policy arguments generally assert that the precepts of utility regulation allow denial of the costs stranded by industry restructuring. I would paraphrase the Regulatory Policy arguments as follows:

> Deregulation of generation is being driven by technological change, not regulatory change. In any case, there never was a regulatory compact that guaranteed 100% recovery and sharing stranded costs strikes a reasonable balance between the interests of customers and investors. Besides, regulation is intended to emulate competition, so theoretically, stranded recovery should be zero.

Q. Are any of these compelling arguments?

A. No, none of them would begin to justify the *de facto* confiscation of utility property represented by denial of stranded cost recovery.

Q. Regarding the Regulatory Compact, are you saying that, in fact, utilities are guaranteed 100% cost recovery?

A. No. Clearly, regulators here in Arizona and across the country have disallowed expenses and investments that were judged imprudent or not used and useful. However, it would be a completely different matter for an investment or expense that has passed the prudence standard after regulatory review to be later denied recovery due to changes in regulation.

Q. Why would later denial of recovery be a "completely different matter?"

A. Denial after approval would be tantamount to defaulting on a contract. Through the regulatory framework in place, regulators have in effect made promises to induce investments. In exchange for these promises, utilities have made investments to fulfill their public service obligations. Denying recovery now would breach the contract between the regulators and the utilities.

Q. Is industry re-regulation driven by technological change rather than regulatory change?

A. It may be the case that technological change is an important driving force behind industry restructuring, but changes in technology have never required regulators to renege on past commitments. No measure of fairness could justify failing to honor

past commitments made by regulators simply because events unfolded differently than they at one time believed.

Q. Are the potential savings available to electric users sufficient justification for reneging on commitments made to utility companies?

A. No. Reneging on past commitments by government is wrong for at least two key reasons. While I am not a lawyer and will not cite cases, it seems obvious that it would be illegal for government to in effect confiscate money from investors. Second, denial of stranded cost recovery would undermine the credibility of government. Without credible government, the citizens of Arizona would suffer because the cost of funding government-sponsored projects would increase and the ability to encourage long-term investment in the State would be seriously set back.

Q. Referring to the second alleged basis for stranded-cost disallowance, Shareholder Risk and Responsibility, what are the reasons cited for less than full recovery of stranded costs?

A. The Shareholder Risk and Responsibility argument asserts that denial of stranded recovery is justified because change in regulation is a risk that investors should

bear. I would paraphrase the Shareholder Risk and Responsibility argument as follows:

> Utility shareholders have known for years that deregulation was coming and could have sold their stock. Investors have already been compensated for the risks of changed regulation through the risk premiums they've earned over the years. Besides, utilities managers have manipulated the system to their advantage and been among the most successful American businesses as a result. If any stranded cost recovery is granted, it should be only enough to just maintain their financial viability, because any more than that would weaken the incentives for mitigation.

Q. Are these compelling reasons for denying full stranded cost recovery?

A. No, absolutely not.

Q. Isn't it true that shareholders have known competition was coming for years and could have sold their stock?

A. Perhaps, but this is beside the point. Shareholders had no reason to believe that regulators would renege on their commitment to allow utilities a reasonable opportunity to earn a reasonable return on and of their prudent investments. If the risk of regulatory reversal of this commitment was actually perceived as a real risk by the investment community, I suspect that the cost of capital to utilities would in fact have skyrocketed over the last several years. This has not happened because

investors have implicitly assumed regulators would honor their long-standing commitments.

Q. But isn't it true that utility investors have been compensated for the risk that a change in regulation could render their investments unrecoverable?

A. No. I am not a cost-of-capital expert, but I think some common sense should prevail here. Several parties have pointed out that utility investment is not risk free. This is true – investors are subject to the prudence and used-and-useful standards and are given only the *opportunity* to recover their investments (business risk). However, it is also true that on the continuum of investment returns demanded by the marketplace, utilities fall on the lower end of the scale. Given this understanding, it strains credulity to suggest that the utilities' moderate premium above a risk-free return has included the risk that regulators could reverse past decisions on cost recovery and flip the industry on its head. Indeed, if the common expectation was that utility investment would be subject to sweeping regulatory changes that could render significant portions of its assets uneconomic, the industry we have today, with its relatively low cost of capital, would not exist.

Q. To this point you have largely discussed investments. What about full recovery for stranded purchased power costs?

A. Disallowing purchased power costs would be even more unconscionable. Citizens' purchase power costs have been passed directly to customers - without profit or markup - through a Purchased Power and Fuel Adjustment Clause ("PPFAC") in Citizens' rates. These costs were previously examined and approved by the Commission. No one can argue that Citizens' shareholders have already been compensated through a risk premium in the cost of capital.

Q. It is true that American utilities are among the most successful companies in the world?

A. I don't know this for a fact, but I trust the Goldwater Institute witnesses, who reported this in their testimony, are reporting their findings factually.

Q. Do you agree, as the Goldwater Institute witnesses have stated, that since utilities have had the chance to earn profits that rival those of the most successful unregulated firms, it does not make sense to protect them from losses like those faced by unregulated firms?

A. Overall, I find their reasoning lacks credibility. First, the losses represented by the denial of stranded cost recovery are extraordinary and not "like those faced by

unregulated firms." As the Goldwater Institute points out in its own testimony, unregulated firms were never saddled with public service obligations that required investment to meet the publics' needs. Unregulated firms could enter or exit a market at will. Further, unregulated firms could hit a home-run and reap enormous profits – regulated firms shouldered earnings caps. One would gather from its testimony that the Goldwater Institute regards stranded costs as little more than ill-gotten gains by utilities for which they now must make amends. In fact, any savings to consumers resulting from disallowance of costs previously approved by regulators would not be a gain, but a transfer of wealth from investors to consumers – a transfer made possible by repudiation of prior commitments.

Q. Should the Commission deny full recovery of stranded costs to motivate utilities to mitigate?

A. No. While holding utilities accountable for taking reasonable steps to mitigate their strandable costs is proper, restricting recovery based on a projection of what level of mitigation should be achievable is arbitrary. The mitigation review process is indeed a large "stick" for motivating vigorous pursuit of mitigation strategies. If the Commission finds that this "stick" is not sufficient motivation, a "carrot" would be a better alternative to a bigger "stick." An incentive, for instance in the form of the ability to share a fraction of stranded costs successfully mitigated, would inspire far

more innovation than would result from the inevitable defensive scramble and time-consuming contentious proceedings created by the threat of severe penalty.

Q. Turning now to the third alleged reason for disallowing stranded costs, Market Impacts, what are the reasons cited for less-than full recovery of costs stranded by the re-regulation of the industry?

A. The area of Market Impacts includes the arguments that stranded cost recovery would discourage business expansion, distort the price of power, and allow utilities to compete unfairly. The most heated issue appears to be the latter – that allowing utilities to recover stranded costs will provide them unfair competitive advantage and increase market power.

Q. Does stranded cost recovery interfere with the working of the competitive market?

A. I would agree that this is a potential problem, but one that is easily avoidable. Under Citizens' approach, where stranded recovery is allowed for those utilities that voluntarily divest their generation assets, the issue of market interference becomes moot. Stranded cost would be determined by the difference between the book value of assets and the prices garnered in the auction. Recovery of stranded costs would be through a fixed monthly charge (based on historical usage) on the bills of

the local distribution company. No accounting manipulation would be possible to, for instance, subsidize competitive operations, nor could the price of power be distorted; power suppliers would compete head-to-head on price.

Q. Turning now to the area of valuation of stranded costs, has there been any consensus on the method of calculation?

A. No, although the administrative approach of net lost revenues and the market approach of asset auction seem to be the leading alternatives based on filed testimony. Several parties who are not Affected Utilities favored the asset auction, while the largest Affected Utilities, Arizona Public Service ("APS") and Tucson Electric Power ("TEP") favored net lost revenues. However, Mr. Bayless of TEP described asset auction as the "only feasible approach" of the other alternatives and suggested that this alternative remain an option, whatever method is selected.

Q. Did any of the parties discuss drawbacks of the asset auction approach?

A. Yes. A number of the parties raised concerns about asset sales, most of which were addressed in my direct testimony. Citizens recognizes that no valuation approach is without drawback, but continues to believe, for the reasons set forth in my direct testimony, that, particularly at this early stage of the national movement toward industry restructuring, market valuation through asset sale, is the best

course for Arizona to take. At a minimum, Citizens urges the Commission to allow sale of generation assets or contracts, under guidelines it dictates, as one acceptable means for stranded cost valuation.

Q. Does this conclude your rebuttal testimony?

A. Yes, it does.

ACAA - 1

BEFORE THE ARIZONA CORPORATION COMMISSION

CARL J. KUNASEK
CHAIRMAN
JIM IRVIN
COMMISSIONER
TONY WEST
COMMISSIONER

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR APPROVAL OF ITS PLAN FOR STRANDED COST RECOVERY	)DOCKET NO. E-01345A-98-0473)))))

ARIZONA COMMUNITY ACTION ASSOCIATION'S REPLY COMMENTS ON THE MAY 14, 1999 FILINGS

Arizona Community Action Association (ACAA) hereby files our comments to the May 14, 1999 Filing of the APS Proposed Settlement.

ACAA supports the contents of the Proposed Settlement Agreement, particularly those which affect low-income customers of APS. ACAA compliments APS for their inclusive settlement process and urges the Arizona Corporation Commission to rule in its favor.

Respectfully submitted this 4th day of June, 1999 by

Janet K. Regner

EXHIBIT
ACAA-1
Admitted

ACAA I

BEFORE THE ARIZONA CORPORATION COMMISSION

Jim Irvin
Chairman
Renz D. Jennings
Commissioner
Carl J. Kunasek
Commissioner

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGH-OUT THE STATE OF ARIZONA	DOCKET NO. U-0000-94-165
	ACAA COMMENTS ON STRANDED COSTS

I. SUMMARY OF ACAA'S COMMENTS

Arizona Community Action Association is highly concerned about the potentially enormous magnitude of stranded costs and their impact on low-income and small consumers; we urge the Commission to be cautious in calculating the amount. As far as priorities, the two top issues are the recovery mechanism (who pays and how) and the price cap/rate freeze. Only those customers in the competitive market should pay stranded costs, since captive customers are already paying these costs and should not be subject to double dipping. The recovery method should be bottom up, asset by asset, with the burden of proof placed on the utilities to produce evidence for every asset or obligation they believe is stranded. The recovery mechanism should be volumetric and based on a per kWh charge to protect low-income and other small consumers.

ACAA's other suggestions include:

- A true-up mechanism is acceptable only if it is limited to being downwardly flexible. Consumers are better served by having stranded costs set at a fixed level which will be the ceiling. That way they have a firm price tag guaranteed not to increase.

- Cost reductions should be the primary method of mitigation as well as utility revenue enhancements.

- The stranded cost definition does not need modification.

- Utilities should file stranded costs as soon as possible and practicable after the generic hearing.

EXHIBIT
ACAA-1
Admitted

- Stranded costs calculation should be limited by the passage of the initial Rule in December, 1996, and only those costs incurred prior to that time should be considered for recovery.

- The Commission should seek to balance the length of the recovery period and the per kWh charge. In order to promote an opportunity for a near-term rate reduction, a longer time frame is better and will keep the per kWh charge smaller. On the other hand, the time frame must be as short as possible to allow consumers to realize the full benefits of competition as soon as possible. The time frame for recovery should be different for each utility and will depend on the magnitude of their stranded costs. The working group recommended three to seven years, which is prudent.

II. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. Betty K. Pruitt, 202 E. McDowell #255, Phoenix, Arizona 85004.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am the Deputy Director and Energy Programs Coordinator of Arizona Community Action Association. I have worked for ACAA for five years, advocating on behalf of low-income utility consumers in many utility proceedings.

Q. WHAT IS THE PURPOSE OF ACAA'S COMMENTS IN THIS PROCEEDING AND WHO PREPARED THESE COMMENTS?

A. ACAA wishes to provide comments on the generic stranded cost issues as put forth in the Procedural Order. We believe that it is important that ACAA provide input on stranded costs from the perspective of low-income consumers, as well as other small consumers.

III. COMMENTS

Q. ISSUE NO. 1: SHOULD THE ELECTRIC COMPETITION RULES BE MODIFIED REGARDING STRANDED COSTS, IF SO HOW?

A. The Rules should be changed only as much as is needed to fill in necessary details. In general, the Rules offer basic consumer protection policies on stranded costs and any

erosion of those protections is unacceptable. The definition of stranded costs should remain as is.

Q. ISSUE NO. 2: WHEN SHOULD AFFECTED UTILITIES BE REQUIRED TO MAKE A STRANDED COST FILING?

A. Utilities should be required to make stranded cost filings as soon as possible and practicable after the Order is issued in this proceeding in order to keep the pace moving. All utilities should file simultaneously so there is no advantage or disadvantage, but separate hearings should be scheduled in a reasonable manner.

Q. ISSUE NO. 3: WHAT COSTS SHOULD BE INCLUDED AS PART OF STRANDED COSTS AND HOW SHOULD THOSE COSTS BE CALCULATED?

A. The Rules adequately address what should be included. As far as how to calculate stranded costs, ACAA recommends that the bottom up, asset by asset approach be used. It is the method most fair to consumers and the burden of proof should be on the utilities to provide evidence of stranded cost for each and every asset or obligation that they believe is stranded. In addition, the bottom-up calculation method accounts for any and all assets whose market values are greater than their book values.

Market values and market clearing prices should be determined by using a combination of market and administrative methods. Some assets should be sold in the market (divested) and the resulting prices used as the market values in the analysis of stranded costs. Market values of other assets and obligations can be determined by using administrative methods. One such method would use the sale prices of similar assets sold by other utilities to estimate the market value of a given asset (i.e., a comparable value approach similar to real estate appraisals). Another approach would be to use independent appraisals of market value when prices of comparable assets sold in the market are not available.

Determining market clearing price is important only for those assets that continue to be held by the generation affiliate of an affected utility. For these assets, independent forecasts and evidentiary proceedings can be used to estimate market clearing prices.

Top-down, revenue lost methods should not be used. While top-down methods can be less complex to implement, their use could result in inaccurate estimates of stranded cost. They do poorly in estimating the amount of stranded costs if utilities lose sales, which is likely to some degree under retail electric competition.

Q. ISSUE NO. 4: SHOULD THERE BE A LIMITATION ON THE TIME FRAME OVER WHICH STRANDED COSTS ARE CALCULATED?

A. Yes. Stranded costs calculation should be limited by the passage of the initial Rule in December, 1996, and only those costs incurred prior to that time should be considered for recovery.

Q. ISSUE NO. 5: SHOULD THERE BE A LIMITATION ON THE RECOVERY TIME FRAME FOR STRANDED COSTS?

A. Yes. The Commission should seek to balance the length of the recovery period and the per kWh charge. In order to promote an opportunity for a near-term rate reduction, a longer time frame is better and will keep the per kWh charge smaller. On the other hand, the time frame must be as short as possible to allow consumers to realize the full benefits of competition as soon as possible. The time frame for recovery should be different for each utility and will depend on the magnitude of their stranded costs. The working group recommended three to seven years, which is prudent.

First, the magnitude of stranded costs should be fixed as a maximum for a utility, then the time period for recovery should be determined and fixed. Although, the time period may need to be shortened if load growth at the distribution level increases faster than assumed, or if the amount of stranded costs to be recovered is adjusted downward. In addition, the time value of money should be considered, with stranded costs adjusted for inflation.

Q. ISSUE NO. 6: HOW AND WHO SHOULD PAY FOR STRANDED COSTS AND WHO, IF ANYONE, SHOULD BE EXCLUDED FROM PAYING STRANDED COSTS?

A. No one in the competitive market should be excluded. Stranded costs should be recovered from everyone, utilities and their shareholders, new entrants to the Arizona market, and consumers who participate in (and expect to benefit from) the competitive market.

However, ACAA supports the rules that state that stranded costs may only be recovered from customers served competitively; so, captive customers still on the standard offer should be excluded. Residential and low income utility customers should not have to pay for any stranded costs resulting from competition in which they do not participate. Consumers not in the competitive market are already paying for these stranded assets through their rates and should not be subject to double dipping.

The stranded costs to be recovered from consumers receiving competitive services should be collected using a non-bypassable distribution access charge applied on a per kWh basis to the volume of energy sales to these consumers.

Regarding recovery of a portion of stranded costs from new market entrants, these funds should be collected using a market access charge (or entrance or license fee) applied on a per kWh basis to the volume of in-state energy sales. The Commission should create a fund which the utilities could draw upon to pay for stranded costs. The non-bypassable distribution access charges and the new market entrant access charges (or license fees) collected for stranded costs should be deposited in this fund.

One method of paying stranded costs while providing a rate reduction which should be avoided is the California model. Consumers there are paying a high price for few benefits.

Q. ISSUE NO. 7: SHOULD THERE BE A TRUE-UP MECHANISM AND, IF SO HOW WOULD IT OPERATE?

A. Wide open true-up mechanisms hold far too much risk for consumers. While it is possible that the true-up could benefit consumers, it is also likely that it could work against consumers. It is better to establish an equitable set amount for stranded cost recovery, giving consumers a firm price tag up front.

The amount of stranded costs to be recovered from consumers and new market entrants should be set as a maximum, which could be adjusted downward if conditions change but could never exceed the maximum. Setting the amount of stranded costs to be recovered as a maximum will avoid surprises and eliminate any additional risk for consumers in the future. Commission staff and interested parties should be able to petition the Commission to reduce the amount of stranded costs to be recovered if conditions change (rather than having a regularly-scheduled reassessment).

Q. ISSUE NO. 8: SHOULD THERE BE PRICE CAPS OR A RATE FREEZE IMPOSED AS PART OF THE DEVELOPMENT OF A STRANDED COST RECOVERY PROGRAM AND IF SO, HOW SHOULD IT BE CALCULATED?

A. Yes. Low-income and other small consumers will face many risks and have few opportunities to benefit from the competitive market. A price cap/rate freeze is a very meaningful mechanism for protecting small consumers against price and cost increases due to retail competition. Since proponents of retail competition have argued that competition

will reduce prices for all customers, no party should have an objection to a price cap/rate freeze.

The price cap for customers in the competitive market and the rate freeze for customers on the standard offer should be based on regulated rates in effect as of 1/1/98.

Q. ISSUE NO. 9: WHAT FACTORS SHOULD BE CONSIDERED FOR MITIGATION OF STRANDED COSTS?

A. Cost reduction is the primary method of mitigation and includes refinancing debt, reducing overheads, re negotiating contracts, retiring uneconomic facilities, and selling excess generation capacity.

ACAA-2

BEFORE THE ARIZONA CORPORATION COMMISSION

Carl Kunasek
Chairman
William Mundell
Commissioner
Jim Irvin
Commissioner

IN THE MATER OF THE APPLICATION OF APS FOR APPROVAL OF ITS PLAN FOR STRANDED COST RECOVERY	DOCKET NOS. E-01345a-98-0473
IN THE MATTER OF THE FILING OF APS UNBUNDLED TARIFFS	E-01345A-97-0773
IN THE MATTER OF COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA	RE-00000C-94-0165

NOTICE OF FILING:
ACAA'S WITNESS LIST AND SUBJECT AREAS
REBUTTAL TESTIMONY

Arizona Community Action Association (ACAA) hereby submits its List of Witnesses and subject areas to be covered at the July 14th hearing. In addition, ACAA is including our rebuttal testimony.

WITNESS

Betty K. Pruitt, ACAA Deputy Director and Energy Programs Coordinator

SUBJECT AREAS

1. General support of the Settlement.
2. Purpose of the competitive market.

EXHIBIT
ACAA-2
Admitted

3. Rebuttal of Staff's recommendations to:
   - balance consumer benefits with desire to stimulate the competitive market
   - adjust the CTC and the MGC
4. Support for Staff's recommendation to:
   - require APS to unbundle its Standard Offer Rates and Direct Access tariff to the same level of detail

REBUTTAL TESTIMONY

Q. Please state your name and business address for the record.

A. My name is Betty K. Pruitt. My address is 2627 N. 3rd. St. Suite 2, Phoenix, Arizona 85004.

Q. Who do you represent and what is your position there?

A. I represent Arizona Community Action Association, the state association for Community Action Agencies across Arizona whose mission is to help low-income people move towards self-sufficiency. ACAA advocates on behalf of low-income people and Community Action Agencies. I am the Deputy Director and Energy Programs Coordinator for ACAA.

Q. Why is ACAA active in utility issues?

A. Electric and gas costs represent a significant portion of a low-income family's budget. Some low-income consumers, especially the elderly on fixed incomes, manage their utility bills by doing without. For some that means turning off the air conditioner or it may mean that they will but less food or medicine to pay their electric bill. ACAA is committed to increasing energy affordability through lower rates and equitable low-income programs.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to provide general support of the Settlement and to respond to portions of Staff's direct testimony.

Q. Has ACAA done any statistical analysis of the Settlement?

A. No. As a small non-profit organization, ACAA does not have the resources to pay a consultant to analyze the tariffs or the stranded costs section. In situations like this, ACAA traditionally relies on the statistical analysis provided by RUCO and Staff. Based on their findings, ACAA can then respond from a policy perspective.

Q. Why does ACAA support the Settlement?

A. It has been a long road leading to electric competition. Most of the parties have been here from the very beginning. We have all fought hard for our constituencies. We have won some and lost some. It is time to take the final steps to bring competition to reality. It is now time to make some compromises and reach consensus. ACAA supports the Settlement because it provides benefits to low-income and residential consumers by reducing rates for those customers held captive and denied access to the competitive market. It also allows more residential consumers into the market and it continues some very important low-income programs.

Q. What do you mean by captive customers?

A. The Rule, as it has evolved, has reduced the number of residential customers allowed into the competitive market during the transition phase. The vast majority of residential and low-income consumers are denied access until competition is fully open. For all practical purposes, they are held captive and denied the opportunity to access promised lower rates through competition.

Q. What benefit does the Settlement provide to captive customers?

A. The Settlement provides a cumulative rate reduction of 7.5% over five years for captive customers. It is my belief that APS recognized the need to provide equitable benefits to their customers excluded from the competitive market.

Q. Staff asserts that the purpose of moving toward the competitive market is to allow customer choice and lower rates and that the Settlement appears to be a good deal for consumers. Do you agree?

A. I believe that all customers should be allowed customer choice and should receive lower rates, but so far all indications are that the free market will discriminate against certain customers, namely low-income, residential, and other small users. These customers for the most part will not be allowed choice in the near term, nor is it likely that they have will have due to limitations on the number of residential customers permitted to choose during transition to competition

much choice under full direct access since small users are the least attractive customers to competitive providers. The Settlement ensures lower rates to residential and low-income customers who will not have choice. The Settlement is an equitable balance between lower rates and choice.

Q. Do you agree with Staff that the Settlement appears to favor rate reductions over the establishment of a competitive market during the transition to competition?

A. No. I believe the Settlement is providing equitable rate reductions to residential consumers in order to give them immediate benefits from competition that they would otherwise be denied. Many parties have acknowledged that residential consumers are not attractive to competitive suppliers. It may be many years before small consumers see the promised benefits of competition, if at all. The residential consumers did not ask for this change to a free market. They face many risks and are likely to get few benefits in the short term. In exchange for the stability and smooth transition their captivity provides, residential consumers deserve, at least, the full rate reduction in this Settlement. The competitive market is further stimulated by increasing the available competitive load for larger customers. In short, small customers get a decent rate reduction, larger customers get more load, and the ruthlessness of the competitive market is held in balance by an equitable solution.

Q. Do you have concerns about Staff's recommendation to raise the market generation credit?

A. Yes. Staff's proposal would seem to further exacerbate the inequities between residential and large industrial customers; but as I stated previously, ACAA has not done a statistical analysis. Consultants and other parties would be better able to answer that. From a policy perspective, I don't want to see any manipulation of the MGC or the CTC which would disadvantage residential or low-income consumers in the short or long term.

Q. What is ACAA's position on Staff's proposal to require APS to unbundle its Standard Offer Rates and Direct Access tariff to the same level of detail?

A. ACAA has always taken the position that more consumer information is desirable. It is important that consumers be able to readily compare apples to apples.

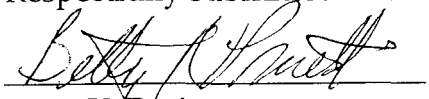
Q. Do you agree with Staff's criteria for Commission approval of the Settlement?

A. I agree that an approved Settlement should have the goals of allowing competition and that it should provide benefits to Arizona consumers. However, I would modify it in the following way: the benefits should be equitable for all Arizona consumers.

Q. Does that conclude your testimony?

A. Yes it does.

Respectfully submitted this 14th day of May, 1999 by



Betty K. Pruitt

The original and 10 copies of the foregoing filed in Docket Control this 12th day of July, 1999.

Copies of the foregoing mailed this 12th day of July, 1999 to the Service list.

ACAA IT

BEFORE THE ARIZONA CORPORATION COMMISSION

Jim Irvin
Chairman
Renz D. Jennings
Commissioner
Carl J. Kunasek
Commissioner

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGH-OUT THE STATE OF ARIZONA	DOCKET NO. U-0000-94-165

ACAA STRANDED COSTS REBUTTAL

I. SUMMARY OF ACAA'S COMMENTS

- While ACAA believes that the Rule defines stranded costs adequately and should not be changed, there are some areas which need more detail. It is possible that many of these details can be proscribed by order rather than a rule change.

- It is likely that only loose generic policies with wide parameters can be established unless the Commission and interested parties know the magnitude of stranded costs.

- ACAA suggests that it is possible to reach some compromise where the utilities get a reasonable degree of specifics in order to file at least an estimate of their stranded costs so this docket can go forward and decisions can be made to fairly balance the public interest with that of the utilities.

- ACAA disagrees with the Attorney General on their assertion that a wires charge is not an acceptable recovery mechanism for stranded costs because it would tend to limit competition by discouraging consumption. Basing a wires charge on actual consumption makes an important consumer connection; they pay for what they use. Any charge which is meters based, generally has a more negative effect on low-income consumers and other low-use consumers. They end up paying more than their fair share. They are effectively penalized for low use. From an environmental perspective, it is in the public interest to continue to encourage energy conservation. Arizona should not undermine the environment at the expense of developing and encouraging a free market.

EXHIBIT
ACAA-2
Admitted

- As we move closer to competition, a price cap is one of the most important benefits available to small consumers. ACAA has maintained that in a competitive market, there are many uncertainties and risks for small consumers. A price cap is one way to mitigate those risks. The Commission has it within their power to assure consumers of this critical benefit. Indeed, most of the parties support a price cap. Proponents of competition have said loudly and repeatedly that it will reduce prices for consumers. Therefore, there should be no opposition to a price cap. If there is, then perhaps we should be looking even closer at how small consumers could end up with the short end of the stick.

- ACAA supports the Staff position that if significantly less than 100% recovery is allowed, then a true up is not needed. And further, ACAA supports the position of Staff, Arizona Consumers Council (Cooper) and Arizonans for Electric Choice (Higgins), among others, which suggests that the optimum and maximum mitigation incentive is to allow less than 100% recovery.

II. REBUTTAL

Issue 1: Rule Change

While ACAA believes that the Rule defines stranded costs adequately and should not be changed, there are some areas which need more detail. It is possible that many of these details can be proscribed by order rather than a rule change. ACAA supports Enron's suggestion (p 25, L 16) that it is not appropriate nor should it be allowable for a utility to recover the lost revenues or the costs of special discount contracts through a stranded cost non-bypassable charge.

The Attorney General proposes changing the Rule to require licenses rather than a CC&N to encourage competition. ACAA believes that consumer protection is paramount and that if the Commission considers adopting this change that it do so with great care and deliberation. In the rush to facilitate ease of entry into the market for suppliers, consumers must not be sold out.

Enron (p 26, L 18), AUIA, AEPCO, ascertain that all customers should pay stranded costs, not just those in the competitive market, and suggests that the rule be modified to express that. ACAA believes that no such change is needed since customers not in the competitive market are and will be paying their share of stranded costs through their standard offer bundled rate. Opening the door for double dipping recovery from captive customers must be resisted and reducing the existing consumer protections in the Rule must be avoided. However, it is

acceptable to clarify that standard offer, bundled bills should contain unbundled line items, which would validate the amount recovered for stranded cost charges.

City of Tucson suggests (Coyle P 5, L 33) that the ACC order the utilities to file estimates of stranded costs before testimony concludes in this docket. ACAA agrees because it is likely that only loose generic policies with wide parameters can be established unless the Commission and interested parties know the magnitude of stranded costs. The impact of stranded costs on customer bills is vital to good public policy development.

City of Tucson (Coyle P 7, L 23) suggests changing the Rule (R-14-2-1607 A) to replace unmitigated with unmitigable. ACAA agrees with this change to clarify the level of effort required by utilities in mitigating stranded costs and proof of mitigation.

City of Tucson (Coyle P 10, L 7) raises concerns about a cost shifting issue by bill savings being offset by increases to taxes. ACAA strongly supports the City's position. Consumers should not be sold a political bill of goods which is essentially a bait and switch tactic that costs them more in the long run.

City of Tucson (Coyle P 5, L 6) recommends that the Rule be clarified that utilities do not have a automatic right to 100% full recovery based on the regulatory compact nor should consumers pay 100%. ACAA is in support.

Issue 2: When should utilities file?

AEPCO states that filing is not possible without specifics in the Rule. City of Tucson, among others, believes it is impossible to determine public policy without knowing the magnitude of stranded costs. Neither the Commission nor interested parties have enough information about the magnitude of stranded costs to suggest or make prudent policy decisions. The only parties who know for sure what the range of stranded costs could be are the utilities. Participating in this docket is rather like playing blackjack, with the utilities as the dealer. They can see our cards, but we can't see all of theirs. The rest of us are just guessing when to hit or stay. ACAA suggests that it is possible to reach some compromise where the utilities get a reasonable degree of specifics in order to file at least an estimate of their stranded costs so this docket can go forward and decisions can be made to fairly balance the public interest with that of the utilities.

Issue 3: What costs should be included and how should they be calculated?

ACAA supports the position of several parties that calls for net calculation of stranded costs and that stranded costs should be eligible for recovery only if they are deemed to have been economic. This requires the utility to take responsibility for its uneconomic decisions.

ACAA opposes the net revenue lost approach and the stock market approach to calculating stranded costs and supports the position of Arizona Consumers Council (Sterman, P 3).

Issue 4: Limitation on calculation period?
No position.

Issue 5: Limitation on recovery period?
ACAA supports the City of Tucson (Coyle P 32, L 28) recommendation that the time period for recovery be decided after the utilities have filed stranded costs estimates. It is difficult to say how long the recovery period should be without knowing how much we are talking about. However, in general, most of the parties agree that five years is acceptable.

Issue 6: Who should pay and how; any exclusions?
ACAA disagrees with the Attorney General on their assertion that a wires charge is not an acceptable recovery mechanism for stranded costs because it would tend to limit competition by discouraging consumption. Basing a wires charge on actual consumption makes an important consumer connection; they pay for what they use. Any charge which is meters based, generally has a more negative effect on low-income consumers and other low-use consumers. They end up paying more than their fair share. They are effectively penalized for low use. From an environmental perspective, it is in the public interest to continue to encourage energy conservation. Arizona should not undermine the environment at the expense of developing and encouraging a free market.

Issue 7: Should there be a true-up?
Depending on the method selected for calculating stranded costs a true-up may not be necessary. ACAA supports the Staff position that if significantly less than 100% recovery is allowed, then a true up is not needed.

Issue 8: Should there be a rate cap/price freeze?
As we move closer to competition, a price cap is the one of the most important benefits available to small consumers. ACAA has maintained that in a competitive market, there are many uncertainties and risks for small consumers. A price cap is one way to mitigate those risks. The Commission has it within their power to assure consumers of this critical benefit. Indeed, most of the parties support a price cap. Proponents of competition have said loudly

and repeatedly that it will reduce prices for consumers. Therefore, there should be no opposition to a price cap. If there is, then perhaps we should be looking even closer at how small consumers could end up with the short end of the stick.

Issue 9: What factors should be considered for mitigation?

ACAA supports the position of Staff, Arizona Consumers Council (Cooper) and Arizonans for Electric Choice (Higgins), among others, which suggests that the maximum mitigation incentive is to allow less than 100% recovery.

Kevin Higgins also suggests using profits from non-regulated activities for mitigation; but the Attorney General disagrees. ACAA suggests that profits generated through use of facilities paid for by ratepayers should be shared with ratepayers by using those profits to mitigate stranded costs.

BEFORE THE ARIZONA CORPORATION COMMISSION

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N THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	Docket No.: No. U-0000-94-165 **NOTICE OF FILING**

Pursuant to the Commission's Fifth Procedural Order dated January 29,1998, The International Brotherhood of Electrical Workers hereby files the rebuttal testimony for Elizabeth S. Firkins in the above captioned matter.

Dated this 4th day of February, 1998

Original and ten copies of the foregoing Filed this 4th day of February, 1998, with:

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BEFORE THE ARIZONA CORPORATION COMMISSION

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IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA.	Docket No.: No. U-0000-94-165

REBUTTAL TESTIMONY OF

ELIZABETH S. FIRKINS

ON BEHALF OF

THE INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS

February 4, 1998

EXHIBIT
IBEW-2
admitted

Summary of Elizabeth S. Firkins' Rebuttal Testimony

The International Brotherhood of Electrical Workers believe the States economic health is linked directly to the States rural communities and industry's participation in these communities.

Stranded Cost recovery is imperative. If the Affected Utilities can verify prudent costs that become stranded as the State transitions to competition, these costs must be 100% recoverable.

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REBUTTAL TESTIMONY OF ELIZABETH S. FIRKINS
ON BEHALF OF
THE INTERNATIONAL BROTHERHOOD OF ELECTRICAL WORKERS
IN DOCKET NO. U-0000-94-165

Q. Please state your name and business address?

A. Elizabeth S. Firkins, 750 S. Tucson Blvd., Tucson, AZ 85716.

Q. What is your position with the International Brotherhood of Electrical Workers (IBEW)?

A. I am an Executive Board member representing Power Production and a Control Room Operator at the Irvington Power Plant in Tucson, AZ.

Q. What is the particular issue you wish to discuss?

A. We are concerned with the numerous respondents that believe the recovery of Stranded Cost is not necessary and prudent to the successful transition to competition.

Q. How do you wish to respond to this concern?

A. It is ironic from our vantage point that the very parties that supported and demanded that power plants be built, are now shying away from the obligation to pay. Plants built in the late 60's, 70's and early 80's were at that time the best the market had to offer. They were more efficient, polluted less and provided a new standard for electric utility service. The cost of these plants was incorporated

into the rate base. Industrial, commercial and residential all paid their fare share. With the advent of generation unbundling, the circumvention of this obligation is being defended and supported.

In the last ten years, electric usage prices have dropped consistently for all classes of users. Our State is enjoying a strong economy and robust employment levels that Arizona has not had in past years. If the Affected Utilities do not have the ability to recover the prudently incurred Stranded Costs, it will not only be the utilities that suffer. The people that have invested their savings in state utilities stock, the workers that have dedicated their careers to the utility business, and the communities that depend on the tax base the plants provide, will also suffer . The economics of our State is closely integrated with industry. Many rural communities depend heavily on industry to provide jobs and other opportunities for the residents of "small town" Arizona. Large industry already has the lowest rates available, and it is reasonable to presume these rates will decrease further when competition begins. Industry will not be damaged by competition unless that industry is a power plant built in a rural community unable to recoup the economic promises made in the past.

When asked, all the new entrants into the market will gladly be the Provider of Choice. The IBEW's concern is with the obligation to serve, the social programs provided and the commitment to communities that have been provided by and through the utilities vested interest in the areas they serve. If utility companies are not allowed to recover Stranded Cost and stranded investments, what happens to these programs and these ideals that have been made available by the electrical companies solid commitment to our State?

The IBEW supports and defends the utility's ability to recover costs incurred because of obligations made and our States need for reliable, safe and continuous power. When Arizona transitions to compeition, all-new market entrants and Affected Utilities must play by the same rules and these rules must include obligation to communities and vestiture in our State.

Q. Does this conclude your comments?

A. Yes, it does. Thank you.

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
COMMISSIONER-CHAIRMAN
RENZ D. JENNINGS
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CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA	DOCKET NO. U-0000-94-165
	NOTICE OF FILING

Carl W. Dabelstein hereby provides notice of filing of his direct testimony as required by the Commission's Third Amended Procedural Order, dated the 5th day of January, 1998, in the above-referenced docket.

RESPECTFULLY SUBMITTED this 21ST day of January, 1998.

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By _____

BEFORE THE ARIZONA CORPORATION COMMISSION

JIM IRVIN
COMMISSIONER-CHAIRMAN
RENZ D. JENNINGS
COMMISSIONER
CARL J. KUNASEK
COMMISSIONER

IN THE MATTER OF THE COMPETITION IN THE PROVISION OF ELECTRIC SERVICES THROUGHOUT THE STATE OF ARIZONA	DOCKET NO. U-0000-94-165

DIRECT TESTIMONY

OF

CARL W. DABELSTEIN, CPA

January 21, 1998

TESTIMONY OF CARL W. DABELSTEIN

SUMMARY OF KEY POINTS

1. The Rules are ambiguous and lack the specificity necessary to properly address stranded costs. They should provide for the recovery of stranded costs, whether or not recorded on the affected utilities' balance sheets. They should be amended to specify the types of stranded costs allowed for recovery, the appropriate calculation period and method, and the time period and mechanism for recovery.

2. The entire stranded cost issue must be resolved prior to the beginning of retail competition. This proceeding and the companies' anticipated stranded costs filings should proceed as rapidly and diligently as possible, in order to meet the existing January 1, 1999 commencement date.

3. Costs that may be considered as stranded include capital and operating costs associated with generation assets, purchased power agreements, fuel and related transportation contracts and regulatory assets.

4. Utilities bear a strong burden of proof with respect to the justification for inclusion of the costs they consider to be stranded, and for which recovery is sought.

5. The most appropriate method for quantifying stranded costs is the "Net Revenues Lost" approach.

6. In computing stranded costs, it is critical to consider the expected remaining service lives and cost recovery periods associated with such assets that have been reflected in the ratemaking process.

7. Stranded costs should be recoverable over a period ranging from five to ten years.

8. The introduction of retail competition is intended to benefit all customers; therefore, all customers should bear some responsibility for stranded costs.

9. There is tremendous uncertainty associated with the process of estimating stranded costs. A mandatory, periodic true-up should be required by the Rules.

10. Parties advocating price caps and rate freezes should be required to provide definitive details of their proposals.

11. Utilities have a clear obligation to take all reasonable and necessary measures to mitigate their stranded costs. Mitigation can be achieved through cost reduction, revenue enhancement, or delaying the introduction of competition. Mitigation efforts should be evaluated on a company-specific basis.

TESTIMONY OF CARL W. DABELSTEIN

SUMMARY OF KEY POINTS

(CONTINUED)

12. Stranded costs have significant accounting and income tax implications. Any inquiry into stranded costs must consider all relevant accounting tax issues.

13. Parties advocating less than full stranded cost recovery should be required to provide detailed justification for their recommendations.

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Introduction

Q. Please state your name and address.

A. My name is Carl W. Dabelstein. My address is 2211 East Edna Avenue, Phoenix, Arizona 85022.

Q. In what capacity are you appearing in this evidentiary proceeding?

A. I am testifying as a consumer of electricity, served by Arizona Public Service Company.

Q. Please state your professional qualifications.

A. A description of my education and professional experience is attached hereto as Appendix A.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to provide input to this very important inquiry into the stranded costs that will likely occur with the introduction of retail competition into the electric utility business in the State of Arizona. Specifically, I will address the various key issues identified by the Chief Hearing Officer in his Procedural Orders recently issued in this Docket. I will then address several additional matters that I believe warrant the Commission's consideration in this most important aspect of electric industry restructuring. As a consumer, I want the benefits of new technology to be realized and to see the price of electricity reduced; however, for retail electric competition to be successful in the long run, it must be implemented in a rational, equitable and economically

efficient manner.

Q. What has been your experience with respect to deregulation and competition in the public utility industry?

A. I have spent considerable time during the past fifteen years observing and assessing the effects of deregulation and the introduction of competition into segments of the public utility business that has been traditionally conducted exclusively by regulated monopolies.

Specifically, as more fully described in the accompanying Appendix A, I spent almost the entire decade of the 1980s as a regulatory consultant, serving a clientele comprised of both utilities and regulatory agencies. In connection therewith, a substantial portion of my time was consumed in identifying and assessing the effects of competition in both the terminal equipment and long distance markets in the telecommunications industry. During the latter part of the 1980s and early years of this decade, my focus turned to the effects of FERC activities deregulating segments of the natural gas pipeline business, such as through its issuance of Order Nos. 500 and 636. Finally, for most of this decade I have been involved in activities associated with the introduction of retail competition in the electric industry, both on a national and regional level. From 1993 through 1995, I participated in electric restructuring activities in the States of Wisconsin, Minnesota, and North Dakota. Also during that period, I served on the committee established by the Edison Electric Institute to address the stranded cost

and accounting implications of the FERC MegaNOPR that became Order No. 888. For the past two years, I have been an active observer of the electric restructuring activities here in Arizona, most recently as Director of the Utilities Division of the Arizona Corporation Commission. In that capacity I coordinated the efforts of five of the six working groups created to address key restructuring issues. I also authored the report containing recommendations of the Working Group and Utilities Division Staff with respect to stranded costs that was submitted to the Commission in early October.

Electric Competition Rules

Q. Do the Electric Competition Rules consider stranded costs?

A. Yes they do. Section R14-2-1601 includes a definition of stranded costs. Section R14-2-1607 addresses the Recovery of Stranded Costs. It provides for the recovery of unmitigated stranded costs, directs the creation of a special working group to address and report on a variety of stranded cost issues, and contemplates the filing of stranded cost estimates by the affected utilities. It also limits the charging for stranded costs to only those customers purchasing power in the competitive market.

Q. Do you believe the Electric Competition Rules are adequate and provide the proper guidance with respect to stranded costs?

A. No, I do not. They are a starting point, but contain some ambiguities and lack the degree of specificity that I feel

is necessary to properly address the stranded cost issue in a reasonable, equitable and timely fashion. All ambiguities should be eliminated and the Rules should be sufficiently comprehensive to minimize opportunities for differing interpretation and/or application.

Q. Please describe the ambiguities that you believe exist in the Rules.

A. First, it is unclear whether the definition of stranded costs would cover unrecorded assets and liabilities. Due to certain requirements under Generally Accepted Accounting Principles, the affected utilities likely have certain stranded costs that do not appear as recorded assets and liabilities in their published financial statements. Some examples are the generation portion of the transitional obligation for postemployment healthcare benefits under Statement of Financial Accounting Standards No. 106, and amounts that may have been ordered by this Commission to be deferred for ratemaking, but which may not be reported under Generally Accepted Accounting Principles as regulatory assets by the respective utilities. There also may be unrecorded obiligations such as those relating to long-term fuel and transportation contracts. The affected utilities should be permitted to request the opportunity to recover all unmitigated stranded costs, whether or not presently reported as assets and liabilities in their balance sheets.

Another ambiguity that exists in the Rules is that with respect to the manner in which the costs of disposing spent

nuclear fuel should be considered for recovery purposes. Section R14-2-1608 permits the costs of nuclear power plant decommissioning programs to be included in the System Benefits Charge; however, nowhere in the Rules is the cost of spent nuclear fuel disposal addressed. The Rules should be clarified to identify whether spent fuel costs are part of stranded costs, or should be treated in the same manner as the costs of nuclear decommissioning.

Q. With respect to stranded costs, what specificity do you believe needs to be included in the Rules?

A. In order to avoid significant differences between the affected utilities, I believe that some standardization is desirable. The types of costs that may be considered as stranded, as well as the calculation period and method used for quantifying stranded costs, should be identified. Moreover, the time period and mechanism to be used for stranded cost recovery should be set forth in the Rules.

Timing of
Stranded Cost Filings

Q. When should the affected utilities be required to file the estimates of their stranded costs?

A. Although the Rules do require the affected utilities to file estimates of their stranded costs, they are silent with respect to the timing of such filings. It is patently obvious that, if the transition to retail competition is to commence and proceed in a rational, efficient, and timely manner, the entire stranded costs issue, including their identification, quantification, and timing and method of

recovery must be resolved as soon as practical. The affected utilities need to have sufficeint guidance from the Rules to begin preparing their stranded cost estimates and filings. Then, the Commission Staff and all interested parties need to have adequate time to thoroughly analyze and object to, if necessary, the companies' requests. All of this takes time, and it must be completed prior to the commencement of retail competition, now scheduled for January 1, 1999. Time is of the essence. This evidentiary proceeding and the required filings of stranded cost estimates should proceed as rapidly and diligently as possible.

Quantifying
Stranded Costs

Q. What costs should be included in stranded costs?

A. Any yet-to-be recovered, prudent operating or capital cost incurred by an affected utility under its traditional obligation to serve, that is likely unrecoverable in a competitive environment with prices reflecting marginal costs, will be stranded. Typically, this will include generation assets, purchased power agreements, fuel and related transportation contracts, and regulatory assets. Other costs may also be considered as stranded, depending on company-specific facts and circumstances. Generation assets are the single largest category of stranded costs. This includes net plant in service, construction work in progress, common plant associated with generation-related activities, fuel inventories and related transportation and handling facilities and equipment, and associated materials and supplies.

Potential stranded generating costs not only include the facilities' current recorded capital costs, but also the amounts that will be required to be expended in connection with their physical removal at the expected end of their respective service lives. Under the Rules, such costs associated with nuclear facilities are to be considered as recoverable under the System Benefits Charge. While clearly not as great, the costs of removing fossil plants at their retirement from service may nevertheless be substantial.

Regulatory assets represent current expenditures that have been deferred by the utilities and/or their regulators for future cost recovery. Such treatment is consistent with the long-standing principle followed by this Commission and other regulatory bodies in attempting to synchronize ratepayer benefit with cost recovery. Regulatory assets may also be created for moderating the rate impact of unavoidable or non-annually recurring events, or promoting utility involvement in public policy initiatives. Among the more common regulatory assets are: previously flowed-through deferred taxes, deferred fuel costs, deferred demand side management costs, deferred pensions and employee benefit costs, and extraordinary losses.

In all cases, I believe that an affected utility has a strong burden of proof with respect to identifying and quantifying stranded costs, and a clear obligation to take all reasonable steps for their mitigation.

Q. How may stranded costs be quantified?

A. Two predominant approaches exist for quantifying stranded costs. "Administrative" approaches essentially represent a process whereby a measure of stranded costs is established based on estimates and expectations of future market prices and asset values in a joint effort by the affected utility, the regulatory agency, and other interested parties. "Market Valuation" approaches use observed valuation of the stranded assets in a current market context. The most frequent administrative approach currently being used is the "Net Revenues Lost" method. The most frequent market valuation method is through asset sales or the divestiture of assets. For reasons more fully covered later in my testimony, due to the tremendous uncertainty associated with projecting market prices for power and other key variables, I believe the risks of estimation associated with a single, up front market valuation of stranded assets are such that the method should not be considered for stranded cost quantification.

Q. Which method do you believe should be used to quantify stranded costs?

A. No method is without its faults or critics; however, all things considered, I believe the most appropriate method is the Net Revenue Lost approach, with some opportunity for periodic true-up. This is a top-down approach that compares the expected future annual revenue requirements for the affected utility's generation business under traditional cost-based regulation with the annual revenues expected to be recovered in a competitive generation market with prices

based on marginal cost. It recognizes that utilities that made multiple investment decisions under the traditonal form of cost-of-service regulation expected to receive a revenue stream to cover the cost of such investments over their expected useful service lives. Under this scenario, stranded cost is measured as the net present value of the annual differences between expected revenues under a continuation of regulation and those likely to be received after the introduction of retail competition.

The Net Revenues Lost approach is the method by which the FERC, in its Order No. 888, has directed companies subject to its jurisdiction to quantify wholesale stranded costs. It considers all of an affected utility's generation costs under traditional techniques understood by regulators, utilities, and other usual participants in the ratemaking process. It allows the calculation to reflect both above-market and below-market assets and costs. It is a relatively simple mathematical calculation once relevant assumptions are known. It eliminates the need for an asset-by-asset determination and can also accommodate periodic true-up to reflect the effects of changes in market prices or other market assumptions.

Calculation
Time Frame

Q. Over what time frame should stranded costs be calculated?

A. The time period over which stranded costs are computed will affect their overall quantification. Under the traditional obligation to serve, utilities made significant long-term

investments on behalf of their customers. Using very long planning horizons, companies undertook construction programs to assure there was sufficient and reliable capacity over long term. These costs were incurred by the respective utilities to fulfill their retail franchise obligations to serve customers directly with the understanding that competing entities would not provide direct retail service, and that there would be a fair opportunity to recover the prudent investments that had been made. Under traditional ratemaking, the costs of long-term investments were spread over their estimated useful service lives, with the intent of properly synchronizing cost recovery with ratepayer benefit. In connection therewith, there was a reasonable expectation that utilities would be given a fair opportunity to recover all such capital costs. In order to correctly compute stranded costs, it is critical to consider the expected remaining service and cost recovery periods that are associated with such assets and that have been reflected in the ratemaking process. Imposing some limit on the period for quantifying stranded costs may not only deny the affected utilities a reasonable opportunity for full cost recovery, but may also deny ratepayers the potential benefits of recognizing the declining net rate base investments occurring over time. Accordingly, it is my belief that, in quantifying stranded costs, the remaining service lives of the affected assets implicit in rates be considered.

Recovery
Time Frame

Q. Over what period should stranded costs be recovered?

A. In addressing this issue, it is assumed that, unlike wholesale stranded costs which are recovered via an exit fee to departing customers, retail stranded costs will be recovered through an on-going wires charge. The length of the recovery period is primarily a function of the size of the stranded investment to be recovered, the number of parties from whom it will be recovered, and the extent to which the parties are interested in concluding the transition period as rapidly as possible. Basically, the longer the recovery period, the smaller the periodic charge but the greater uncertainty and delay until retail competition is fully achieved. Conversely, the shorter the recovery period, the greater the charge, but also the greater liklihood of recovery and more rapid completion of the transition to full retail competition. Whatever, the recovery period ultimately determined as appropriate by this Commission, it should be sufficiently long to provide the affected utilities a reasonable opportunity to recover their stranded costs.

The other states addressing stranded cost recovery in connection with electric industry restructuring have established recovery periods generally ranging from five to ten years. Considering all relevant factors, I recommend a recovery period of ten years, but would not be strongly opposed to a period as short as five years.

Stranded Cost
Payment Responsibility

Q. From whom should stranded costs be recovered?

A. Among the critical elements of any stranded cost recovery plan are the parties to whom such charges will be levied and the type of charge mechanism to be used. As stated, in their present form, the Electric Competition Rules provide for stranded cost recovery only from those utility customers taking competitive power (R14-2-1607.J). No specific guidance is given for the type of charge to be used for stranded cost recovery. Rule R14-2-1607.H permits an affected utility to request Commission approval of "distribution charges or other means of recovering unmitigated stranded costs from customers..." I believe all customers should bear some responsibility for stranded costs and that the proper recovery mechanism is a non-bypassable, across-the-board, end user wires charge that reflects the true nature of underlying stranded costs. I would not object, however, to some distinction being made between the stranded cost charge to be assessed the parties using competitive power, and those customers remaining as standard offer customers, recognizing that the latter are already paying stranded costs through their service rates.

Q. Why do you believe that all customers should bear some stranded cost responsibility?

A. I believe that all customers should bear some responsibility for stranded costs for two reasons. First, the major driver for the move to implement retail competition is lower rates

for everyone in the long run. Electric restructuring is perceived to bring overall benefits to society in general, through improved efficiency in the industry and prices that more closely reflect true marginal costs. If it is truly believed that all consumers will ultimately benefit from the introduction of retail competition, then all consumers should bear some responsibility for stranded costs. This theory is consistent with the manner in which responsibility for stranded costs was spread in the deregulation of the natural gas pipeline industry, and is the way that certain portions of the costs of the local telephone loop plant, previously assigned to the interstate jurisdiction prior to deregulation of the long distance telecommunications business, are now recovered via subscriber line charges assessed to all end users, irrespective of whether they initiate or receive any long distance calls. This approach is also used in the property tax mechanisms in many states whereby some portion of all citizens' tax payments support the public schools, whether or not the taxpayers actually have or have had children attending school. The perceived overall benefit of free public education to society in general warrants such broad-based cost support.

I also believe that stranded costs should be recovered from all consumers for economic reasons. Those customers opting to procure competitive power may not see some or all of the benefits of competition in their final electric bills, if they bear the entire burden for stranded costs. To the extent that stranded costs are fully recoverable, and the

period for their recovery is shorter than the horizon over which they were quantified, and recovery is permitted only from parties taking competitive power, the amounts paid by the latter, including the stranded cost charge, may actually exceed amounts paid by standard offer customers paying regulated rates with no additional stranded cost obligation. For example, assume a host utility has a bundled rate of 10 cents per kWh, comprised of 5 cents for generation and 5 cents for delivery. Further assume that competitive power is available for 3 cents per kWh. To the extent that the applicable stranded cost charge is greater than the 2 cent differential between the power cost of the host utility and competitive power, there is no economic incentive for the customers of the host utility to take the competitive power. The alternative source price per kWh (3 cents generation + 5 cents delivery + the stranded cost charge) would exceed the 10 cent price currently avalilable. A key reason why this may occur is illustrated by the simple example of an 8 percent $100,000 mortgage loan. With a thirty-year term, the monthly payment is $734. That increases to $956 when the term is reduced to fifteen years. With any cost recovery scenario, as the period for recovery is shortened, and all other factors held constant, the annual recovery amount will always increase.

To the extent that consumers of competitive power will not be able to realize the full economic benefit of changing power suppliers, there will be an economic disincentive to leave their host utility. True competition can only occur

at the margin. Whatever ultimately may be the stranded cost mechanism approved by this Commission, it is critical that it be designed to promote efficient competition, meaning that all suppliers must compete on the basis of their marginal costs, and such supplier differences be reflected in the prices paid by consumers. It is clear that the true benefits of retail competition can only be realized if all consumers are required to participate in stranded cost recovery. It is apparent that R14-2-1607.J must be amended to broaden the base for stranded cost recovery to include all consumers for whom utilities made long-term commitments in connection with the traditional obligation to serve.

Q. Should new customers bear an obligation for stranded costs?

A. Yes, I believe they should. They should pay their fair share as though they had been served all along. The affected utilities have traditionally planned their systems to accommodate customer growth. Moreover, an incentive should not be created for customers to attempt to bypass stranded cost obligations by trying to appear as though they are a "new" customer.

Q. Should departing customers be charged for stranded costs?

A. To the extent they are truly physically leaving the area served by the host utility, they should bear no further stranded costs. Effects of routine customer departures have traditionally been considered in utilities' generation planning processes. The impact of such departures will, to a certain extent, be offset by new customers of the utility

who will assume their respective share of stranded costs. Moreover, the departing customers will likely be subject to stranded cost charges by the incumbent utility in the new area to which they relocate.

Q. What about customers that opt to self-generate?

A. R14-2-1607.J states that reductions of electricity sales due to customers self-generating shall not be used to calculate or recover stranded costs. I believe that the Rule should be amended to require some stranded cost compensation from those customers who decide in the future to self-generate. Self-generation may be a way some parties choose to bypass their stranded cost responsibility. It could also lead to economically perverse results. If, for example, the host utility has marginal costs of 4 cents per kWh and a stranded charge of 5 cents per kWh, the customers may opt to self-generate at a marginal cost of 7 cents--3 cents above the utility's marginal cost. That type of uneconomic bypass would result in an overall efficiency loss. To eliminate any incentive for stranded cost bypass, the charge should be made recoverable from all customers, including those that elect self-generation.

There are two ways that may be used for collecting stranded costs from customers opting to self-generate. First, many such customers will continue to purchase emergency, back-up power from the host utility. In such circumstances, the customer's allocated share of stranded costs could be incorporated as part of the standby service charge. Second,

it may be possible to recover stranded costs from customers that depart to self-generate through some form of exit fee.

Q. Should those parties currently served under interruptible rates and special contracts be obligated to compensate their host utility for some portion of the stranded costs?

A. These customers present an interesting situation. By definition, interruptible customers go off-line at times of high system demand. They are billed under rates based upon the full cost of service, less some credit to represent the higher peaking capacity costs the utility avoids when such customers' service is suspended. With respect to the special contract customers, under this Commission's current policy, such customers must have economically viable power supply alternatives. By signing the special contracts, they agree to remain with their host utility, and benefit by receiving certain rate concessions. Their special rates reflect all variable costs, plus some contribution toward fixed costs. Other customers benefit as well, by not having their rates increase to cover the lost margins that would result due to customer departures, absent such agreements. Clearly, the stranded cost implications for interruptible and special contract customers are different from those of full service, firm customers.

I believe that a distinction should be made with respect to interruptible customers such that they bear somewhat reduced stranded cost charges, depending on the specific manner in which the costs of serving such customers are determined and

reflected in the resulting rates. Utility generation capacity planning and service requirements for this class of customer are less than those associated with firm service customers. As a result their stranded cost burden for capacity-related costs should be less. On the other hand, I do believe that interruptible customers should be assigned full responsibility for energy-related stranded costs.

With respect to special contract customers, it is my belief that they should, as a group, be assigned their fair share of the stranded cost burden, but the ultimate recovery thereof should be a matter for negotiation between the respective parties. The remaining body of ratepayers should not be burdened with any portion of the stranded costs allocable to, but not recoverable from, this group of customers.

Q. For purposes of developing a stranded cost charge mechanism, on what basis should costs be allocated between regulatory jurisdictions and between customer classes?

A. Stranded costs should be allocated jurisdictionally and to customer classes in a manner consistent with the respective utility's current ratemaking treatment of the actual costs themselves. This should affect a recovery of stranded costs in relatively the same proportions as cost recovery would have been expected to be achieved under a continuation of regulation. This appraoch to allocation has been adopted by several of the states considering electric restructuring.

Q. What mechanism should be used for billing and recovering stranded costs?

A. I believe the most appropriate mechanism for billing and recovering stranded costs is a non-bypassable, across-the-board end user wires charge with both energy and demand components. This is consistent with sound economic principles and reflects the underlying nature of the stranded costs.

True-up of
Stranded Cost Estimates

Q. Should there be a periodic true-up of the utilities' estimates of stranded costs?

A. Yes, there most certainly should be a periodic reexamination of administratively determined stranded costs. Presently, the Electric Competition Rules provide for the possibility of such reconsideration. R14-2-1607.L states that the Commission may order regular revisions to the estimates. I believe the Rules should be amended to require periodic true-ups and corresponding revisions to the stranded cost charges throughout the recovery period. While the calculation methodology and estimates of stranded costs could be agreed upon before retail competition begins, the actual calculations and associated charges would be determined on a periodic basis reflecting realizations of the relevant variables. Initially, this could be annually, but as experience and confidence in the quantification process is gained, the frequency could be extended.

Q. Why do you believe there should be a periodic true-up?

A. There is considerable uncertainty in attempting to quantify stranded costs. The process is based on a number of factors that, at this point, are nearly impossible to predict. It is pure speculation to project what the markets and prices for power will be in the future. To the extent estimates of stranded costs are overstated, utility shareholders will be unjustly enriched and consumers will be economically detrimented. If the quantifications are understated, the opposite effects on these stakeholders will occur.

Clearly, the most significant variable in quantifying stranded costs is the market clearing price for power. It is implicit in every computational methodology, both administrative and market-based. It is based on a variety of factors including customer demand, market structure, new accounting and tax rules, generation and fuel mix, generation and transmission capacity, the level of interest rates and inflation, advances in technology, and new laws and governmental regulations. At this point, trying to forecast the market price for power over the stranded cost calculation horizon would probably be as much as or more difficult than trying to guess the price of a single stock on the New York Stock Exchange throughout that same period. An example of the risks in trying to estimate the prices and costs of electricity can be seen in the problems encountered in New York and California as the regulators in those states made determinations and rulings in connection with QF power under the requirements of PURPA. Many of the stranded costs of electric utilities in those states can be

attributed to such errors in estimation.

I believe that a periodic true-up is necessary to assure that electric restructuring in Arizona is carried out in a manner that protects the public interest. Such a revisiting does not have to guarantee a dollar-for-dollar recovery (regulation never did that), but at a minimum should enable prospective adjustments of the stranded cost charge to reflect changes in major uncontrollable variables, for the protection of both consumers and utility investors.

Price Caps and Rate Freezes

Q. Should price caps and rate freezes be a part of the stranded cost recovery program?

A. Although I am aware that other states addressing retail electric competition are considering price caps and rate freezes as a part of their overall plan, I am taking no specific position on whether this Commission should adopt them for Arizona. However, I do wish to comment on the matter.

In the Stranded Cost Working Group meetings, several of the participants stated their preference for a price cap or rate freeze. No one, however, offered any substantive details as to how such a plan should be developed, implemented, or operated. For example, what rates should be frozen or capped--the total price for service, or just the distribution portion? In the competitive environment, generation will be deregulated, transmission will

essentially be totally FERC-regulated, leaving only distribution service for the ACC to regulate. Does the Commission have the continuing authority to include generation and transmission service in a price cap or rate freeze if they no longer regulate those business segments? Does a price cap or rate freeze comport with the Commission's responsibility to provide utilities under its jurisdiction a reasonable opportunity to recover the cost of providing service. I believe that any party advocating price caps or rate freezes should be required to answer these and other questions and supply all of the relevant details of their proposal.

Mitigation of
Stranded Costs

Q. What do the Rules say about mitigation of stranded costs?

A. R14-2-1607.A requires the utilities to take every feasable, cost-effective measure to mitigate stranded costs, and cites expanding markets or the scope of their service offerings as examples of mitigation techniques. I totally agree.

Q. What factors should be considered for the mitigation of stranded costs?

A. In considering mitigation, it is important to note that many stranded costs are obligations or sunk costs which, by definition, cannot be mitigated. They can only be reallocated, or offset by additional revenues. Accordingly, many mitigation proposals are merely targeted to shift the cost responsibility between utility investors, consumers, taxpayers, wheeling customers, or independent power

producers. As a result, not all mitigation strategies being advanced are necessarily based on considerations of fairness or equity when the ultimate bearer of this financial responsibility is identified.

Mitigation can be achieved in two principal ways: cost reduction and containment efforts and revenue enhancement strategies. Mitigation can occur when affected utilities reduce generation and operating costs to be more in line with those of the market. This may be accomplished by reducing operating costs (both labor and non-labor) via productivity and efficiency gains, and by repowering or retrofitting existing plants and replacing inefficient generating units and equipment as well as making changes that facilitate fuel switching. Another mitigation tool available is the renegotiation or buy-out of above market, or otherwise uneconomic, fuel, transportation, or purchased power contracts.

Stranded cost mitigation may also occur when affected utilities are able to generate additional revenue sources. Such efforts may include the development of new energy sales opportunities at prices above the respective utility's actual variable fuel and O&M costs, the sale of existing owned capacity and purchased capacity rights, and the sale of emmission (SO2 and NOx) credits. Utilities with substantial transmission capacity will find marketing to be a more effective strategy than will utilities without such interconnection possibilities.

I believe an important distinction must be made with respect to revenue enhancement as a mitigation tool. To the extent that additional revenues are derived from the generation assets or other resources which underlie the revenue requirements upon which current regulated rates are based, they may be considered as being available for mitigating stranded costs. Revenues derived from assets and other resources that are currently non-jurisdictional or non-utility, and for which the utility shareholders are at risk, should not be used as an offset to stranded costs.

A third way that stranded costs may be mitigated is through accelerated depreciation of generation assets or accelerated amortization of regulatory assets. Unless, however such accelerated expense recognition is accompanied by commensurate cost recovery, this exercise is not mitigation, it is merely a transfer of wealth from utility investors to consumers. A way for this technique to achieve true mitigation is through the use of some type of rate freeze (such as has been done with nuclear assets in California) or a negotiated earnings sharing agreement between an affected utility and its regulators (similar to that which exists between APS and the ACC). In either case, overall costs of service may be declining and a portion of the savings are offset by the accelerated expense recognition rather than flowing the savings in their entirety back to ratepayers.

The stranded cost burden can also be reduced through time. By delaying the introduction of competition, the utilities

will be able to continue recovering all of their stranded costs through bundled full service rates. As capital investments in generation assets continue to be recovered through depreciation charges, there will be a reduced, yet-to-be recovered amount at the time competition is ultimately introduced. I mention this for information purposes only; it is not my recommendation to change the scheduled January 1, 1999 implementation date. I would, however, not be opposed to such a postponement if it would mean a more efficient and equitable move toward competition.

As stated, I strongly believe that the affected utilities have an obligation to take every reasonable measure to mitigate stranded costs. However, because the circumstances of what constitutes reasonable and prudent mitigation efforts can be expected to vary widely between companies, a generic approach for analysis should be avoided. Mitigation efforts should be evaluated on a case-by-case basis. It is also important to note that mitigation efforts themselves are not without costs; they may generate additional stranded costs. Therefore, I believe the Electric Competition Rules should be amended to permit each affected utility to independently demonstrate that their mitigation efforts were reasonable and cost beneficial, based on all relevant facts and circumstances. In addition, amounts prudently spent in connection with mitigation efforts should be included in the balance of recoverable stranded costs.

Source of the
Market Clearing Price

Q. How should the market clearing price be determined?

A. As stated the market clearing price for power is the most critical and sensitive variable used in computing stranded costs. Other states are using various measures for the market price. As California begins its foray into retail electric competition, the utilities in that State will use 2.4 cents per kWh as the intitial market price for computing stranded costs in 1998. That represents the estimated short-run avoided costs for the year and will be trued-up at a later date. Ultimately the price on the spot market known as the California Power Exchange will be used once that market is firmly established. In Michigan, the utilities will use an averavge price based on regional cost data from the Michigan Electric Coordinated System. Such price estimates are required to be trued up annually.

One likely source of a market price available for Arizona is the Dow Jones Palo Verde Electricity Index. I believe, however, that such an index may not be totally reliable for the long run. Factors such as substantial excess generating capacity in the Southwest and effects of new participants trying to establish a foothold in the market may produce pricing trends that may be unrepresentative and and likely unsustainable in the long run.

In establishing a market clearing price for purposes of quantifying stranded costs in Arizona, a key consideration

is whether an ex post make-whole adjustment to actual is part of any true-up process. While a total make-whole process may be inappropriate (regulation provided only an opportunity to recover all costs, not a guarantee) due to the extreme difficulty in projecting the market clearing price, I believe that strong consideration should be given to adjusting stranded cost recovery to eliminate the effects of errors in estimating the market clearing price. To the extent such an adjustment is allowed, the actual market price could be determined by summing all electric revenues for capacity and energy in Arizona during the measurement period, and dividing the result by actual kWh sales during that same time frame.

Accounting Issues

Q. Does the issue of stranded cost quantification and recovery raise any significant accounting implications.

A. Industry restructuring and the stranded costs likely to result therefrom have significant accounting implications.

Q. What are the accounting implications?

A. An assessment of the accounting implications associated with stranded costs must first begin with an understanding of the unique nature of accounting principles and practices used in the public utility industry. In most instances, the same accounting principles that apply to businesses in general also apply to public utilities. The differences that exist, however, are significant and are totally attributable to the traditional process whereby utility rates are based on the

costs of providing service. By having the power to determine the costs upon which rates are based, regulators can create economic impacts that must be appropriately considered in utility accounting and financial reporting. The accounting used by utilities has evolved over the years, and gained widespread acceptance by accounting standards setters, governmental agencies, regulators, and the financial community.

The key accounting standard affecting utilities is Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation," ("SFAS No. 71"), which defines a regulated entity and contains standards that must be complied with in preparing financial statements issued by public utilities. All of the affected utilities in this proceeding keep their books in accordance with SFAS No. 71.

Under SFAS No. 71, the most important difference between the accounting used by regulated utilities and unregulated businesses is the ability of regulators to create assets ("regulatory assets") by deferring to future periods (and therefore recoverable in future rates) costs which would otherwise be charged to expense in the current period. With their legal authority to identify the types and amounts of costs to be recoverable in rates, regulators have traditionally been able to provide the necessary level of assurance through rate orders that any amounts ordered to be deferred for ratemaking purposes meet the criteria to

be reported as assets in published financial statements. Many of the stranded costs of utilities are such regulatory assets.

Other utility industry specific accounting standards have been issued by the Financial Accounting Standards Board ("FASB") in response to concerns over the financial implications of non-traditional ratemaking practices. SFAS No. 90, issued in 1986, addressed the proper accounting for costs associated with cancelled power plant projects, while SFAS No. 92, issued in 1987, dealt with accounting for plant costs deferred for future rate recovery under commission-approved phase-in plans.

With the emergence of competition and deregulation in the utility industry, many of the companies discovered they no longer met the criteria set forth in SFAS No. 71 to continue to be characterized as a "regulated enterprise" for accounting purposes. In response thereto, in 1988 the FASB issued SFAS No. 101, "Accounting for Discontinuation of Application of SFAS No. 71." The thrust of this new standard is that, when an enterprise ceases to meet the criteria of SFAS No. 71, it must discontinue its application, and remove from its books of account the effects of actions by regulators that would not have been recorded by enterprises in general. Typically, that means writing off all recorded regulatory assets and liabilities.

In 1995, an additional accounting standard having stranded

cost implications was issued by the FASB. SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of" addressed concerns that arose within the accounting profession and in the financial community, particularly with respect to reported assets of utilities, given the extent to which deregulation and restructuring was occurring in the industry. SFAS No. 121 lists certain events (including a significant change in the regulatory climate in which a company operates), the occurrence of which requires the company to consider whether any of its assets may have been impaired. For this purpose, the carrying amount of the affected asset must be compared to the expected future undiscounted value of related net cash flows. If the recorded amount exceeds the projected cash flows, then asset impairment must be recognized and the book value of the asset reduced to its fair market value.

Any inquiry into stranded costs quantification and recovery must consider the requirements and effects of SFAS No. 71, 101, and 121. The major potential threat to the affected utilities of being forced to go off of SFAS No. 71 would be that they immediately write-off all generation-related regulatory assets. Then, to the extent that the generating assets are impaired, further write-offs would be required under SFAS No. 121.

As the electric utility restructuring efforts proceed, it has become patently obvious that, as written, SFAS No. 71 did not fully contemplate the direction that deregulation

and competition are taking today. Notwithstanding the direction and guidance existing under SFAS No. 71, 90, 92, 101 and 121, there has been considerable uncertainty raised in connection with many of the restructuring plans being considered. Some of the questions being raised include:

a) When does a utility go off SFAS No. 71-- upon the announcement of a date certain, or on that date certain?

b) May a stranded cost that would otherwise have to be written off under SFAS Nos. 101 or 121, continue to be reported as an asset if its recovery will be allowed as part of billings for distribution service?

In May 1997, the Emerging Issues Task Force of the FASB agreed to consider these issues as part of an inquiry into entities facing deregulation, specifically, the three major electric utilities in California. In August, EITF 97-4 concluded that companies should discontinue using SFAS No. 71 for business segments when legislation or a regulatory decision is issued that contains sufficient detail to reasonably determine how a transition plan will affect the deregulated portion of the business. In addition, it concluded that regulatory assets and liabilities may remain on the regulated books of account if they will be collected through cash flows (i.e. stranded cost charges) of the business segments continuing to be regulated.

At this point, I believe the Electric Competition Rules lack the specificity that would require the affected utilities to discontinue following SFAS No. 71. Sufficient support exists through EITF 97-4. I do believe, however, that as

soon as the Rules contain sufficient information for utilities to make the required assessments of deregulation as contemplated under EITF 97-4 (perhaps when they are amended as a result of this evidentiary proceeding) the companies will have to go off of SFAS No. 71. I have discussed this matter with and provided copies of the Rules and the report of the Stranded Cost Working Group to certain members of the AICPA Public Utility Committee and the NARUC Subcommittee on Accounts and all concur with my assessment.

Based on the foregoing, the potential adverse impact on the affected utilities of less than a full opportunity to recover their stranded costs is obvious. Not only do the Rules have to clearly provide that opportunity, but also should include specificity with respect to quantification methods and recovery mechanisms that provide the required degree of assurance of recovery necessary, in order to avoid the companies having to suffer significant write-offs against retained earnings, unnecessarily. Expanding the base from whom stranded costs will be recovered and including a periodic true-up mechanism are examples of ways to raise the degree of assurance of stranded cost recovery.

Q. Are there other stranded cost accounting issues?

A. Yes. There are several potential stranded cost accounting issues for which there exists little direction in the FASB accounting standards. Moreover, specific accounting guidance from the FERC with respect to the proper accounting for stranded costs or related revenues has been relatively

sparce. For example, uncertainty exists with respect to the manner in which stranded cost recovery revenues may be applied to specific costs, and in the way that a generating plant should be depreciated when it is expected to be operated for its full remaining physical life, which is far in excess of the established stranded cost recovery period. Another unresolved issue is an on-going inquiry by the FASB into accounting for liabilities related to the closure or removal of long-lived assets. This is relevant to both nuclear decommissioning costs and costs of removing fossil plants at the end of their respective service lives.

I believe that the affected utilities should be required to include detailed descriptions of their proposed accounting for stranded costs and related revenues as part of their stranded cost estimates filed under R14-2-1607.G. Moreover, the true-up procedure I have previously advocated in this testimony would afford all parties an opportunity to address the effects of any new accounting rules or standards issued subsequent to the commencement of the transition period.

Tax Issues

Q. Do stranded costs raise any tax issues?

A. Yes. The quantification and recovery of stranded costs create a number of significant tax issues. These include the manner in which any tax benefits previously "flowed through" in the ratemaking process and existing deferred tax reserves and unamortized investment tax credits may be considered in

the process of quantifying stranded costs. In addition, a potentially significant issue exists with respect to the continuing ability of nuclear utilities to obtain a current income tax deduction for contributions made to external decommissioning trust funds.

Q. Please describe the "flow-through" issue.

A. In many instances certain revenues and expenses are treated differently for book (ratemaking) and tax purposes. Such differences may be characterized as either permanent differences or timing differences.

Permanent differences are revenues or expenses that are considered for either book or tax purposes, but not the other. Examples of permanent revenue differences include interest on municipal bonds and the equity component of AFDC, which are treated as income for book purposes, but not recognized for tax purposes, and contributions in aid of construction which are income for tax purposes only. Some permanent expense differences include lobbying expenses and portions of the costs of business meals and entertainment which are recorded expenses on the books, but are not allowed as tax deductions. Permanent differences affect only the current accounting period.

Timing differences occur when revenues and expenses are recognized in different accounting years for book and tax purposes. Over time, the differences completely reverse, and the cumulative effect on book and tax income is the

same. For public utilities, the greatest timing difference is that which exists with respect to book and tax depreciation, with the latter reflecting accelerated methods and shorter lives. Under generally accepted accounting principles, deferred taxes must be recorded for the effect of all timing differences. Deferred income taxes offset the effect of the timing differences reflected in the calculation of the current income tax expense, thereby providing a levelizing effect on the <u>total</u> income tax expense. In ratemaking, the practice of including deferred income taxes in the cost of service is labeled "tax normalization." The inclusion of deferred taxes in the cost of service will initially increase the overall revenue requirement. As the timing differences reverse, the opposite will occur. Since deferred taxes are not allowed as tax deductions, there is a tax-on-tax effect associated with deferred taxes. Accordingly, with combined Federal-state tax rate of 40%, the effect of $1 of deferred taxes is $1.67 in revenues.

While generally accepted accounting requires deferred taxes to be recognized for <u>all</u> book-tax timing differences, that is not necessarily the case in utility ratemaking. Except for certain depreciation-related timing differences that the Internal Revenue Code and IRS Regulations require to be normalized, regulators have had the liberty to include in ratemaking only the deferred taxes they felt appropriate. In many instances, they did not allow deferred taxes to be recognized for some timing differences that produce larger

current tax deductions, thereby lower income tax expense and correspondingly lower annual revenue requirements. When certain timing differences are considered in computing the income taxes in ratemaking, but deferred taxes are not allowed, the benefits of the timing differences are said to be "flowed-through" to ratepayers.

Because the effects of timing differences reverse over time, the tax benefits flowed through in the past in the form of lower utility service rates, will become greater tax liabilities and increased revenue requirements in the future. There is an implicit promise in the "flow-through" ratemaking methodology that, when the higher tax obligations arise in the future, the affected utility will be allowed to recover such increased costs in rates.

Over the years, the ACC has required most of the utilities under its jurisdiction, including all of the affected utilities in this proceeding that are tax-paying entities, to flow-through some tax benefits in ratemaking. The companies' ability to recover the higher future taxes that will result as the timing differences reverse, will disappear as soon as they are required to compete in a competitive market, and the Commission is no longer setting rates for the deregulated business segments. As I stated previously in this testimony, the affected utilities should be permitted to include in their stranded cost estimates all generation-related, previously flowed-through, but yet-to-be recovered, deferred taxes.

Q. Please explain the issue dealing with the use of deferred tax reserves and unamortized tax credits in the process of quantifying stranded costs.

A. As very capital-intensive entities, public utilities have received significant tax benefits through the use of accelerated tax depreciation and the investment tax credit. Accelerated depreciation enables taxpayers to depreciate assets for tax purposes more rapidly than for book purposes, thereby lowering tax liabilities in the early years of an asset's service life. The investment tax credit permitted taxpayers a permanent reduction in their tax liabilities, based on a percentage of amounts spent for the acquisition of certain classes of plant and equipment.

The intent of the Congress in creating the benefits of accelerated depreciation and the investment tax credit was to encourage taxpayers to make capital investments, thereby creating jobs and stimulating the economy, through both lower current income taxes or the permanent forgiveness of tax. In the early years of their existence, there were no ratemaking rules or restrictions placed on regulators, limiting or directing their treatment of such benefits in utility ratemaking. As a result, many regulators immediately flowed the benefits through to ratepayers in the form of lower service rates.

As the trend toward such "flow-through" expanded during the 1960s, the Congress became alarmed that it would thwart the purpose for which these benefits were created by depriving

utilities tax of benefits available to other taxpayers, reducing Federal tax receipts due to the reductions in the utilities' gross revenues and taxable income, and failing to match fairly the tax benefits arising from capital asset expenditures to the ratepayers who actually bore the capital costs in rates. This resulted in the enactment of legislation now incorporated into the Internal Revenue Code and IRS Regulations that severely restrict the ability of regulators to flow-through tax benefits associated with accelerated depreciation and investment credit in utility ratemaking.

Deferred taxes associated with timing differences arising due to accelerated depreciation methods and shorter tax lives must be recognized in ratemaking. The deferred taxes must be included in tax expense, and the corresponding accumulated deferred tax reserve may either be deducted from rate base or reflected in capital structure at a zero cost for rate-of-return purposes. The ratemaking treatment afforded deferred taxes relating to any book-tax timing differences other than accelerated methods and shorter lives for depreciation are not covered by the IRS Rules of laws.

Utilities have traditionally accounted for the investment tax credit by deferring it on their balance sheets, and then amortized it as a reduction of income tax expense over the lives of the assets that gave rise to the credit. The IRS Rules and tax laws require a sharing of the credit. In connection therewith, utilities must elect either of two

ratemaking options. Under Option No. 1, the unamortized balance of the credit is deducted from rate base, but the annual amortization amount is recorded "below-the-line," and may not be treated as a reduction of income tax expense for ratemaking. Under Option No. 2 (that which is most common in the utility industry), the amortization of investment tax credit is used to reduce income tax expense for ratemaking, but the unamortized balance is not deducted from rate base.

One issue arising in other states assessing retail electric competition, and one that could appear here, is the proper treatment of the deferred tax balances and unamortized tax credits in calculating stranded costs. I believe that such amounts may be considered as offsets to related stranded capital costs, but the Internal Revenue Code and IRS Rules clearly require that there must be a proper synchronization of these tax benefits with specific stranded costs to which they relate. To the extent any portion of the capital cost of a stranded asset is excluded in the calculation, there must be a corresponding reduction in the offset provided by the related tax benefits.

I base my opinion with respect to deferred tax reserves on the "consistency requirement" in Code Section 168 (i)(9)(B). It requires that a ratemaking authority (i.e. the A.C.C.) use an estimate or projection of a regulated company's income tax expense, depreciation expense, and balances of accumulated deferred taxes that are all consistently determined with respect to each other and with respect to

rate base. A similar consistency requirement exists for investment tax credit in Code Section 46 (f)(10). Basically, these serve to limit regulators' ability to consider the deferred tax reserves and unamortized tax credits to the extent the related capital costs are considered.

Although I am not aware of any specific IRS guidance on this offset issue in dealing with stranded costs, during the past few years there have been a number of IRS Private Letter Rulings addressing the ability to consider offsets in other circumstances, such as with public utility phase-in plans, plant cost disallowances, and assets removed from the scope of regulation. In all instances, the IRS found that, when any such capital cost adjustment is made to regulated rate base, a corresponding adjustment must be made to the related tax benefits. Although technically, Private Letter Rulings may not be cited as precedents, they are nevertheless useful in showing the IRS position on certain issues. In addressing this position, the IRS has been totally consistent.

Q. What is the issue with respect to the tax deduction for nuclear decommissioning?

A. The costs of dismanteling and removing power plants at the end of their service lives are recovered as a component of book depreciation expense. For tax purposes, however, tax deductions for removal costs are generally only allowed when the removal is occurring and amounts being expended. The recovery of removal costs in rate revenues with no corresponding deduction for cost of removal accruals gives

rise to higher current tax liabilities and creates a deferred tax asset during the years the asset is in service. Decommissioning expense is a type of removal cost, and also recovered in book expenses over the service life of the respective nuclear power plant. The principal difference is the significantly larger cost involved with nuclear plants.

The Tax Reform Act of 1986 added Section 468A to the Internal Revenue Code and provided utilities with nuclear plants an opportunity to obtain a current tax deduction for contributions made to external decommissioning trusts. Such deductions are limited to the lower of the Schedule of Ruling Amount ("SRA") or the applicable cost of service amount for the year. An SRA, required to be filed with and approved by the IRS annually, specifies the maximum annual payments allowed to be made to the decommissioning fund. It must be based on the same assumptions used by the applicable regulators in establishing the amount allowed for inclusion in cost of service for ratemaking.

Deregulation of the generation segment of the electricity business raises questions about the nuclear utilities' continuing ability to meet the requirements for the tax deductibility of payments to external decommissioning trusts. With the introduction of retail competition and resulting departure from cost of service ratemaking for such utilities, it is unclear whether they will continue to meet the conditions set forth in Internal Revenue Code Section 468A. For example, on what basis would an SRA be

prepared? The inability of the utilities to deduct decommissioning fund deposits currently could have significant stranded cost implications.

Stranded Cost Recovery

Q. Are there any other issues you believe should be addressed?

A. Yes. Although I believe the Electric Competition Rules do contemplate and provide for the recovery of stranded costs, a number of the participants in the Stranded Cost Working Group expressed strong reservations against full or partial stranded cost recovery. Many felt there should be some sharing of the burden between ratepayers and shareholders, while others believed no stranded cost recovery should be allowed. None of the parties offered any substantive explanation or justification for requiring utility investors to assume any of the stranded costs. No one provided any evidence that utility investors have ever been compensated the higher risks of competition.

Q. Do you have a recommendation?

A. Yes I do. I believe that the affected utilities should be provided a reasonable opportunity to recover their stranded costs. They made the underlying investments and incurred in good faith the related obligations under a traditional obligation to serve that was intended to provide a business environment such that they had a reasonable expectation to recover the costs of providing safe, reliable, service. Stranded cost recovery should not, however, be automatic. The affected utilities have a strong burden of proof with

respect to the assets and costs for which recovery is being requested. They must take all reasonable steps to mitigate their stranded costs and be prepared to demonstrate they have not already been compensated therefore in any way.

Q. Does this conclude your testimony?

A. Yes it does.

PROFESSIONAL QUALIFICATIONS

Q. What is your educational background?

A. I graduated from the University of Nebraska with a Bachelor of Science Degree in Business Administration, major in Accounting. I also received a Master of Business Administration Degree, concentration in Finance from Rockhurst College in Kansas City, Missouri.

Q. What has been your professional experience?

A. Upon graduation from college in 1968, I was employed by the public accounting firm Arthur Andersen & Co. in its Omaha office. During such employment, I participated in and and directed audits and other engagements involving banks, healthcare facilities, public utilities, insurance carriers, and other clients.

In 1971, I accepted a position reporting to the controller at Central Telephone & Utilities Corporation at its then headquarters in Lincoln, Nebraska. During the five years I was employed by CTU, I directed such activities as financial and regulatory accounting and reporting, internal auditing, budgeting, corporate acquisitions and divestitures, rate case and other regulatory filings, banking relations, and corporate financings.

From 1976 to 1981, I was employed by Kansas City Power & Light Company. My responsibilities included the corporate audit function, operations budgeting, and rate case filings in Kansas and Missouri and with the Federal Energy

Regulatory Commission. During that period, I also served as a member of the Internal Control and Auditing Committee of the Missouri Valley Electric Association, and the Finance and Accounting Committee of the Standardized Nuclear Unit Power Plant System.

From 1981 to 1991, I was employed as a Senior Project Manager for a regulatory consulting firm and successor firm, directing rate case, management audit, and other engagements for a clientele that included utility companies, public service commissions, and intervenors to regulatory proceedings

From 1991 through 1996, I was employed as an internal consultant with Northern States Power Company in Minneapolis, Minnesota. My responsibilities included accounting, taxation, and cost allocation issues in rate cases and special regulatory proceedings, performing investment evaluations, accounting and tax research, developing cost recovery plans, and advising senior management in connection with the development of performance-based ratemaking proposals and strategic policies for competing in a competitive electric utility industry.

In late 1996, I accepted a position as the Tax Research Coordinator for Tucson Electric Power Company. My main responsibilities included tax research and planning, preparation and review of corporate tax returns, and meeting

with representatives of tax authorities. I also directed the team charged with the responsibility for developing and implementing a system for strategic business unit reporting.

In January, 1997 I was appointed Director of Utilities for the Arizona Corporation Commission. In that capacity, I directed a staff of approximately ninety professional and clerical employees responsible for overseeing railroad and pipeline safety in Arizona and for regulating the water, telephone, electric, and natural gas distribution utilities in the State. I resigned from that position in December.

Q. What are your professional certificates and qualifications?

A. I hold Certified Public Accountant certificates issued by the Boards of Accountancy in Nebraska and Kansas. I am a member of the American Institute of Certified Public Accountants, the National Association of Railroad and Public Utility Tax Representatives, and the National Association of Radio and Telecommunications Engineers ("NARTE").

Q. What technical licenses do you hold?

A. I hold an Advanced Class FCC Radio License and a Technician Class II NARTE Certification with regulatory and antennas endorsements.

Q. What is your teaching experience?

A. I have developed and conducted seminars on a variety of topics for employees of public utilities and regulatory agencies. I have also taught classes on behalf of the

U.S. Telephone Association. I am presently a member of the faculty of the NARUC Regulatory Studies Program at the Public Utility Institute at Michigan State University. In connection with my teaching, I have written three training books: Public Utility Income Taxation and Ratemaking, Public Utility Working Capital, and Generally Accepted Accounting Principles for Utilities.

Q. What has been your experience in regulatory proceedings?

A. During the past twenty-five years, I have participated in numerous rate cases and other regulatory and litigation proceedings involving electric, gas transmission and distribution, telephone, water and wastewater utilities conducted in Alaska, Arizona, California, Colorado, Connecticut, District of Columbia, Florida, Indiana, Kansas, Maryland, Minnesota, Missouri, Nevada, New Mexico, North Carolina, North Dakota, South Dakota, Virginia, and Wisconsin, as well as the National Energy Board of Canada, and the Federal Energy Regulatory Commission. I have testified on matters involving financial and regulatory accounting, auditing, cost allocation, financial forecasts, capital and operations budgeting, taxation, corporate acquisitions, holding companies, valuation and transfer pricing, deregulation, the cost of capital, industry restructuring, and regulatory policy.

Q. In what proceedings have you testified before this Commission?

A. I have previously testified on behalf of the Commission

Staff in proceedings involving Tubac Valley Water Co., Santa Cruz Electric, Sun City Water & Sewer, Sun City West Water and Sewer, Southern Union Gas Company, Southwest Gas Company, Tucson Electric Power Company, Continental Telephone Company of California, Continental Telephone of the West and U.S. West Communications, Inc.